EVALUATION DEPARTMENT SPECIAL STUDY

EQUITY OPERATIONS

ANNEXES

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European Bank
for Reconstruction and Development

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This study has been prepared by the EvD, and is circulated under the authority of the Chief Evaluator. The views expressed herein do not necessarily reflect those of the EBRD Management or its Board of Directors. The relevant Operations teams were invited to comment on it prior to internal publication. Any comments received will have been considered and incorporated at the discretion of the EvD. While the EvD considers the Management's views in preparing its evaluations, it makes the final decisions about the content of its reports.

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Abbreviations

DSF	donor-supported fund
EBRD	European Bank for Reconstruction and Development
EPMU	Equity Portfolio Monitoring Unit
ERUS	Russian stock market
EU	European Union
EvD	Evaluation Department
FI	financial institution
GDP	gross domestic product
GP	general partner
ICT	information and communication technology
IFC	International Finance Corporation
IFI	international financial institution
IPO	initial public offer
IRR	internal rate of return
LC2	Local Currency and Capital Market Initiative
PEF	private equity fund
RUB	Russian rouble
SME	small and medium-sized enterprises
US$	US dollar

Annex 1. Summary of key equity policies and operations

This annex reviews :

- the EBRD Equity Policy Framework
- the evolution of equity operations
- the current Strategic Framework for direct equity.

A1.1 Equity Policy Framework

The use of equity instruments is intrinsic to the EBRD policy framework and it is acknowledged in the following documents:

- Agreement Establishing the Bank
- Compendium of Financial Policies
- Operations Manual and Guidelines.

Articles 11.1 (ii) and (iii) in the **Agreement Establishing the Bank** defines equity as one of the principle means used by the EBRD to foster transition by sharing risks and influencing behaviour. Article 12.2 of the Agreement sets out the restrictions on acquiring a controlling interest in investee companies.

The equity policy statement in the **Compendium of Financial Policies** elaborates on the key elements of equity including: (a) the need for additionality; (b) an inability to ever take a controlling interest, taking interests in the range of 5-30 per cent; (c) flexibility in its ability to take Board representation; and (d) an intention to exit when its role is completed (which might take 3-5 years).

The **Operations Manual and Guidelines** includes a draft Chapter 9 on equity issues, dated April 2010, which sets out the organisational structure and procedures for originating, managing and divesting equity interests.

A1.1.1 Managing conflicts of interest between debt and equity

The Bank's financial policies prohibit it from taking a controlling stake or management responsibilities in the companies in which it invests (except for exceptional circumstances, such as corporate recovery cases). This would require a level of involvement in detailed management issues that is not consistent with the Bank's objectives or resources. The provision of both debt and equity creates the conditions for a potential conflict of interest, although in practice, the actual conflict arises mostly in circumstances of financial stress.

Typically, when the EBRD decides to take equity, it will aim at acquiring stakes in the range of 5-40 per cent, but both smaller and larger percentages can be justified in particular circumstances. The EBRD aims for an overall ex-ante target return for equity investments of 20-30 per cent. The EBRD may nominate one or more persons to join the board of an investee company, to achieve goals such as fostering good corporate governance, influencing the company's medium- or long-term strategy, providing the company with useful technical guidance and/or protecting the EBRD investment.

There is no systematic approach to giving priority to equity or debt in a financial structure; this decision will be a function of factors such as compliance with sound banking principles, additionality, an improvement of the risk return profile of the transaction, or the promotion of transition through channels such as improvements to corporate governance. The process to enhance returns and mitigate risks includes due diligence, shareholder's agreement provisions (e.g. tag-along and drag-along rights in the event of a sale) put and call options, the estimation of a realistic entry price, and a clear exit strategy.[1]

A1.1.2. Process for investing, managing and divesting equity interests

The EBRD's process for approving and managing equity has been subject to change following a review in 2014. This sub-section provides a broad overview of the current

1 A drag-along right allows a majority shareholder of a company to force the remaining minority shareholders to accept an offer from a third party to purchase the whole company. When a majority shareholder sells their shares, a tag-along right will entitle the minority shareholder to participate in the sale at the same time for the same price for the shares.

arrangements; although there are changes happening on a regular basis, in most cases these are minor.

Pre-investment procedures

Governance processes for equity investments largely mirror debt, with the exception of the Direct Investment Facility, the Local Enterprise Facility, the Private Equity Co-Investment Facility and Venture Capital Investment Programme, which have their own streamlined processes. Approval for investments from these funds was delegated to the Small Business Investment Committee, established in 2010. Other equity investments are approved by the Operational Committee and subsequently the Board of Directors, after review and approval by the Equity Committee. There is a range of documents that need to be prepared, including a Concept Review Memorandum, a Structure Review Memorandum, a Final Review Memorandum approved by the Operational Committee, and an Operational Report approved by the Board.

The Operations Leader has responsibility for negotiating the shareholders' agreement and defining transition impact objectives, and a member of the Value Creation team is responsible for protecting the Bank's interests. The provisions negotiated in the shareholders' agreement, which govern investment and exit, are the primary mechanism to mitigate these risks. Put options can provide an important means of exiting from the investee company, particularly if they are assigned to a creditworthy parent of the sponsor. However, the effectiveness of put options to the company is constrained by the availability of funds and accounting earnings that exceed the value of the put – provisions that are often not available if the company is experiencing financial difficulties.

The EBRD may, or may not, accept board representation as it provides access to information and the potential to influence decision-making, but there are also costs in terms of unreimbursed expenses, the opportunity cost of time, reputational risks, and access to inside information that can make it difficult to exit from listed companies. In contrast to the role of the Operations Leader, a board nominee is liable to act in the best interests of the company in overseeing its management, and in this respect, a director's actions are subject to personal civil and criminal penalties (for which the Bank will indemnify appointees, if necessary). The EBRD is always a minority investor, which limits its ability to control and influence company decisions and it will rarely have the technical expertise that allows nominees to participate actively and deeply in the management of the business. Nominees may be staff, or accredited external parties acting on behalf of the EBRD.

Post-investment procedures

Most of the management requirements for an equity investment are similar to a loan, and relate to the monitoring of the general commercial and financial health of the company. Nominee directors are required to file reports on board meetings with the EBRD, and they are subject to annual evaluations. Value Creation Leaders are required to produce a monitoring report for each equity investment, providing details on the company's prospects, a recommended valuation and an update on the expected exit strategy. The format of this monitoring report was updated in 2007 to reflect features unique to equity investments, such as the status of value drivers.

Fair value is based on the market price for listed investments, equity or net asset values for unlisted investments, or intrinsic values of options. If there is an expectation that the value of an asset has fallen by more than 30 per cent for more than 12 months, then this would constitute a trigger event indicating that the fair value was impaired. All fair value valuations are signed off by the head of the EPMU, the Credit Portfolio Review Unit, the Director of the Equity team (for direct equities and equity derivatives), and the Director of Equity Funds (for equity funds). The Management of Equity Risk reviews the equity portfolio on a quarterly basis to ensure the results of the trigger assessments are valid. Similarly, the **Equity Committee** reviews a detailed portfolio report on a quarterly basis by equity category, country and sector.

The **Equity Committee** reviews exit proposals, which can be in the form of a private trade sale or a public placement of shares. To the extent possible, the EBRD will try to secure the exit route via the negotiation of a put and/or call agreement with a counterparty, which is usually the company or the sponsor of the operation. The timing of the exit will depend on a range of factors, such as transition impact status and the financial performance of the company. Before a decision to exit is taken, an Exit Approval Memorandum will be submitted to the **Equity Committee**. This happens in advance of detailed negotiations on exit price and any other key terms. The purpose of this procedure is to define a negotiating mandate, giving bankers the authority (and reasonable flexibility) to agree terms with the client. Following the successful conclusion of negotiations within this mandate, the investment may then be sold.

The Board of Directors receives regular reports on equity investments, including: (a) the Annual Strategic Portfolio Review; (b) the Annual Financial Intermediaries Report, including details on private equity funds (PEFs); (c) the Annual Budget and Business Plans; (d) Quarterly Institutional Performance Reports; (e) Quarterly Performance Reports; (f) the Board Monthly Information Report; and (g) Exit Information Notes.

A1.2 The evolution of equity operations

In July 1994, the EBRD issued an information note on its approach to equity fund projects. It stated that the provision of equity to SMEs was a primary objective, and PEFs provided a means of leveraging the EBRD's operating effectiveness. The case for additionality was clear, as in many cases the PEFs could not mobilise funds without the participation of the EBRD.

Following the privatisation of many state-owned enterprises in the EBRD's countries of operations during the 1990s, there was a rapid increase in the number of SMEs, and they lacked access to equity due to low levels of savings and a lack of foreign investors. Equity was seen as being most important in the early stages of a firm's life, and direct investment funds financed by foreign investors were seen as one of the few sources of equity capital available in these countries. In practice, foreign PEFs were not very active in countries of operations compared with the West. There were perceptions amongst private equity investors of high levels of risk, the use of external investors was not well understood by local firms, and there was a lack of entrepreneurial and management skills relative to the West. The size of investments was also an issue, as they tended to be small in countries of operations. Yet they still required the same levels of support as larger firms, without generating the additional management fees.

The EBRD has been involved in various types of PEF, ranging from seed capital and second-stage venture capital through to industry funds and potentially portfolio funds with publicly listed investments. Due to the riskiness of PEF investments, selection criteria were weighted towards factors such as additionality and an ability to disburse funds in a timely manner. Reaching the local private sector was a primary objective of the Bank's operational strategy in the financial sector. It was envisaged that the PEFs in which the EBRD was an equity investor would generate co-financing opportunities. It was assumed that the EBRD would typically exit from PEFs after 10 years, and it would be a function of PEFs' ability to exit through a private sale or a public listing.

The EBRD pursued a policy of active management through representation on PEF supervisory bodies, such as boards and investment committees. PEFs are required to comply with standard audit and reporting requirements, and regular reports on the evolution of PEFs are presented to the Financial and Operations Committee.

In 1995, the EBRD issued an early-stage equity progress report, which noted that the Bank's Guidelines for the Medium Term had identified equity investment as one of its priorities. The Privatisation and Restructuring team had developed and was managing a range of early stage equity instruments consistent with these Guidelines. The main instruments were: (a) Special Restructuring Programmes, which were designed to facilitate the restructuring and subsequent privatisation of state-owned enterprises; and (b) Post Privatisation Funds, including the Regional Venture Funds in Russia, which were designed to help restructure enterprises that were already privatised.

The early-stage equity instruments blended equity with grant finance to reduce risks to bankable levels and enable investments that otherwise would not be feasible. In many cases, the EBRD was the only investor in these projects and provided a high degree of management support. The smaller size of early-stage equity investments (typically between US$300,000 and US$3 million) would help to bridge the gap between standard Bank projects (US$5 million for a maximum stake of 35 per cent) and, for example, the SME project in Russia, which covered the lower end of the spectrum, with investments typically between US$5,000 and US$50,000. The high risks attached to early stage equity were managed through portfolio diversification, specialised fund managers, a legal structure by which it could gain management control in the event of financial distress, technical cooperation, and provisioning of up to 20 per cent.

Early-stage equity experienced a range of problems, including long delays in project preparation due to slow government project approvals, and slow and complex technical cooperation procurement approval procedures. Further issues arose from the difficult commercial environment, an unwillingness to share power with outsiders, and weaknesses in the legal environment that did not protect minority shareholders. The medium-term plan envisaged that ECU500 million of early-stage equity money and ECU300 million of technical cooperation funds would be invested in central and eastern Europe and Russia initially, followed by other Commonwealth and south-eastern European countries.[2] There was an intention to diversify investments into industrial sector plans, partner with selected corporate firms, develop management buyout instruments and seek co-financing as soon as practicable.

In 2007, Management made a presentation to the Financial and Operations Committee entitled **'EBRD Equity Financing: Past Experience, Current Practices and Future Approaches'** (EBRD, 2007). The third Capital Resources Review, approved in 2006, indicated that annual equity commitments were about €0.7 billion. This increase would result in an aggregate equity share of 18 per cent for the third Capital Resources Review period, compared with 13 per cent over the second Capital Resources Review period approved in 2001. FIs continued to comprise the largest element in the portfolio at about 60 per cent, although the overall portfolio composition was showing an increase in the corporate sector and investments in Russia. The increase in relative importance of demand for the EBRD equity compared with debt was due to buoyant growth and consequent demand for expansion capital, which outpaced the growth of equity markets/institutions.

Equity provided important transition impact opportunities due to its ability to influence corporate governance in banks and equity funds. At the same time, the EBRD had a favourable experience with equity during the second Capital Resources Review, and could respond to that demand by taking more risks. Management acknowledged there were differences in debt and equity, and equity was more labour intensive during the preparation and operating periods. These costs were offset by the potential for higher transition impacts, although there was greater risk, as there were less explicit remedies available than in a lending relationship. In most cases, the EBRD invested in ordinary equity, although it had the ability to invest in quasi-equity instruments.

The EBRD had no systematic approach to selecting equity versus debt; it was a function of market demand. In fact, due to the nature of the EBRD operations, it often provided both equity and debt to FIs. Concerns about conflicts of interest between equity and debt holders were seen as an issue only in the event of financial distress. Conflicts of interest were addressed by full disclosure, separate teams for each instrument, no cross-subsidisation across instruments, and acknowledgement that the protection of a loan was a priority in a distressed situation.

Different types of equity investment were identified, including: (a) direct investments with partners, ranging from listed companies to multinational sponsors and regional and local sponsors; and (b) PEFs through co-investments or direct investments in the funds. Investments in PEFs were seen as offering a number of important advantages compared with management in house, as they were less hierarchical and there was more local decision-making, an emphasis on control of management, specialisation on equity and strong financial incentives. Offsetting these factors, PEFs were expensive, accounting for 10-20 per cent of gross returns, and were not suitable in places where political risks needed to be mitigated or privatisations required political support.

In 2007, an analysis of financial performance for 2006 showed that listed funds were by far the most profitable type of PEF, and FIs were the largest and most profitable sector. Telecoms and pharmaceuticals had been an important source of capital gains in the past, but at a lower order than FIs. In 2006, central and eastern Europe was the primary region of operations, although in recent years there had been a shift toward Russia and south-eastern Europe. For the period 1999-2006, disbursements ranged from €300 to €500 million per year; the median investment was about €5 million; and the average holding period was 5.5 years. The evidence suggests that vintages from 1998 to 2002 achieved the greatest financial returns, and dividends were not an important source of returns. Larger investments generated high rates of return and were much less resource intensive. Transition Impact Monitoring System ratings for equity investments were comparable to, if not better than, those for debt.

During this period, the EBRD benefited from rapid rates of growth of stock markets in central and eastern Europe, coupled with large early-mover investments through privatisation in listed FIs. In the future, it was expected that the sector composition would remain the same, but the focus would be on generating value rather than investment through privatisation in undervalued assets. In many cases, it would be necessary to participate in smaller transactions, at a

2 ECU is the European Currency Unit used prior to the euro until 1999.

distance, with local owners. To meet this challenge, the EBRD developed an in-house Corporate Equity team, increased the number of staff in the FI group working on equity, upgraded ICT and established reporting systems that complied with International Financial Reporting Standards, created a central EPMU, introduced regular reviews of nominee directors, and developed a new mezzanine product to service SMEs.

In 2009, the EBRD presented to the Board a memorandum, 'EBRD Equity Policies, Processes and Strategic Issues' (EBRD, 2009). This reiterated the justification for equity presented to the Financial and Operations Committee in 2007, based on provisions of the Agreement Establishing the Bank and elaborated in the Compendium of Financial Policies. The memorandum provided an update on the portfolio and indicated that from 1992 to 2009, the composition of the historical portfolio was: (a) global sponsors (27 per cent); (b) equity funds (24 per cent); (c) local firms (22 per cent); (d) listed firms (22 per cent); and (e) other (5 per cent).

The EBRD often co-invested with global and regional sponsors, who were typically majority shareholders seeking political risk cover or specific country and sector knowledge. These co-investments were evenly split between FIs and corporates, and about 50 per cent were made in central Europe and the Baltic states. PEFs were the second most important category of equity investment, and were split between standard and donor-supported funds. Standard PEFs were located in a wide range of sectors and performance had exceeded unspecified market comparators. In the past, most donor-supported funds had been supported with grants, and were part of special initiatives such as Regional Venture Funds and Post Privatization Funds. Almost 60 per cent of PEFs had a regional focus and targeted sectors such as telecommunications and services.

Investments in local firms through the Direct Investment Facility and the EBRD–Italy financed Local Enterprise Facility were the third most important category of equity. These projects were typically quite small, providing investments of less than €5 million; they were difficult to value, labour intensive, represented minority interests and had no certain exit route. These firms were fairly evenly split between FIs and corporates, but the regional distribution was more fragmented, with Russia featuring as a major destination. Investments in listed firms were the fourth category, and they were fairly evenly split by value between privatisations and the IPOs of private companies, and dominated by FIs in central Europe and the Baltic states.

A1.3 Current strategic framework

A1.3.1 Private equity funds

The Equity Funds team had a number of objectives, including:

- build private equity institutional capacity in the EBRD regions of operations, increasing the depth and diversification of the use of this funding instrument
- increase the availability of long-term equity capital, including in segments that would not be reached by the EBRD directly
- assist in improving corporate governance, and facilitate the transfer of skills from fund managers to investee companies
- help establish private equity as an asset class and develop a sustainable base of international and local investors
- support the EBRD strategic innovation initiatives through engagement with relevant sector/ industry specialist funds (e.g. venture capital, clean tech, etc).

Participation of the EBRD was seen as additional, as funds would not proceed without its participation, due to high political risks that it could help mitigate through its integrity due diligence and compliance with social and environmental safeguard standards. Historically, returns from the EBRD PEF portfolio had exceeded market comparators.

The EBRD introduced a pilot integrated approach in 2012. This was designed to help move the private equity industry forward by addressing remaining structural gaps, and help develop the pool of institutional capital available for investment in private equity in Poland and central Europe. The integrated approach was developed by the Equity Funds team, the Office of the Chief Economist, the country team and the LC2 team. An important component of LC2 was the development and effective deployment of local pools of institutional capital (particularly pension funds). The Equity Funds team would contribute to this by helping to raise awareness of opportunities in central and south-eastern Europe, thereby attracting institutional investment funds, and by capacity-building.

In addition, the Office of the Chief Economist, together with LC2, would help conduct policy dialogues to remove or highlight regulatory restrictions. Traditionally, regional PEFs had centred their operations on Poland, which had a large pool of institutional capital in its pension system, and so the integrated approach focused on Poland to: (a) increase the participation of international investors in PEFs targeting Poland and central Europe; and (b) encourage the emergence of a class of local institutional investors, including local pension funds and insurance companies, and provide a demonstration effect for other countries to then deploy capital across central and south-eastern Europe more widely.

In **November 2012**, Management made a presentation to the Financial and Operations Committee seeking to **broaden the PEF regions of operations**. It was noted that investment guidelines and fund documentation had restricted EBRD investments to countries of operations using an opt-out provision. Management wished to broaden this remit to invest in knowledge economy investments and PEFs active in the Mediterranean region and Africa. This shift would not affect transition impact objectives, because: (a) consequent diversification would not exceed 30 per cent of capital; (b) the funds would be primarily active in countries of operations at the time of disbursement; and (c) the EBRD investment would always be leveraged, as its average commitment is between 20 and 30 per cent of the fund size. This change was an acknowledgement that PEFs' regional focus often did not align with countries of operations, and that the EBRD wished to increase its engagement in the southern and eastern Mediterranean region; the change would also avoid problems of Management alignment associated with opt-out clauses.

In 2013, the Equity Funds team presented to the Board the **Integrated Approach for the Further Development of the Venture Capital and Private Equity Ecosystem in the Baltic States**. This was the first integrated approach designed and approved under the Updated Guidelines on the Integrated Approach to EBRD Operations, and it was prepared jointly by the the Office of the Chief Economist and the Equity Funds team. The Integrated Approach would enable the EBRD to address key transition challenges in the Baltic states' venture capital and private equity ecosystem, and deliver transition impact through policy dialogue and targeted outcome-driven engagements and correlative investments into venture capital and PEFs. Investments made in the Baltic states under the Integrated Approach were expected to occur over a three-year period, and to be worth around €80 million across four to five funds. It was envisaged that technical cooperation support for this Integrated Approach would be sought from donors in due course.

The concept was consistent with the Knowledge Economy Initiative, LC2 and the Small Business Initiative. Fully functioning venture capital and private equity sectors were important to achieve transition, due to their focus on innovation processes and ability to provide financial support to companies through periods of commercial or financial distress. Venture capital and private equity had a direct impact on competitiveness by making funding available for risky but potentially innovative and lucrative new business opportunities.

Similar to many other central and eastern European countries, the first PEFs in the Baltic states were principally established in the late 1990s. The Integrated Approach identified a range of constraints to investment, including: (a) the lack of information on venture capital and private equity funds; (b) the need for capacity-building; (c) changes to legislation and regulations affecting venture capital and PEFs; (d) the development of networks for wider regional integration of this asset class and access to global markets; and (e) the need for support for the early-stage development of commercial ideas. The project would generate transition impact by demonstrating new financing methods, transferring skills and developing frameworks for markets. Additionality would be derived from the EBRD's role as the largest investor in equity funds in the region.

A1.4 Direct equity

A1.4.1. The Institutional Investment Partnership

The Institutional Investment Partnership was established to help the EBRD tap into the large sovereign wealth fund pool of capital and attract it to investments in countries of operations. The EBRD did not favour the IFC's Asset Management Company model, as it would require a separate asset management vehicle with dedicated infrastructure and resources. The Asset Management Company had 40-50 staff, and its independent status meant it potentially had the capacity to cherry-pick individual IFC projects. There was potential for the IFC to be subject to decisions taken by the Asset Management Company, which it did not agree with but could not directly influence due to its minority interest status. There were also concerns about the potential for conflicts of interest between the IFC and the Asset Management Company, and about possible differences in compensation packages. The Asset Management Company receives carried interest on portfolio performance, which is likely to increase the costs of operation. By comparison, the Institutional Investment Partnership structure was based on a passive co-investment concept that could be accommodated within the EBRD existing procedures and infrastructure. The Equity Participation Fund investment vehicle would be an English limited partnership. In line with the objective to strengthen the Bank's equity business, the Banking Department consolidated the Equity platform under a single Equity Group.

A1.4.2. The Equity Participation Fund

In 2013, it was envisaged that the Institutional Investment Partnership would create a sub-fund, the Equity Participation Fund, that would consist of around €1.0-1.5 billion of minority equity stakes, direct equity and possibly sub-funds by region or sector (although there was potential for misalignment). Investments would follow the EBRD investment strategy and the initial vintage would start from 2014. The base case annual business investment in equity was assumed to be €500 million, slightly below the 12-year investment average. The Institutional Investment Partnership could potentially be seeded from the existing portfolio of assets, with additional fund investments of up to €500 million. The EBRD would retain ownership of the underlying assets, and issue equity participation notes to limited partners in the Equity Participation Fund that could participate in 30-50 per cent of the EBRD direct investments, with higher levels in such regions as central Europe and the Baltic states that were approaching graduation. Equity participation notes would be entitled to dividends and exit proceeds from specific underlying equity investments. The fund would have a life of 12 years, a five-year investment period, and a target first closing in the first half of 2014.

In March 2014, the Equity Participation Fund concept was presented to the Board.[3] The Equity Participation Fund objective would be to mobilise long-term capital from institutional investors such as sovereign wealth funds and pension funds. It was noted that direct equity investments of more than €10 million had achieved high transition impact scores and financial returns that exceeded market comparators. Global investors were underweight in equity in the region, indicating an opportunity. The Equity Participation Fund would provide investors with direct access to a diversified pool of direct equity investments. The EBRD could offer up to 25 per cent of total annual bank investments. Despite being a minority investor, the EBRD would use its board memberships, local presence and track record to influence investee companies.

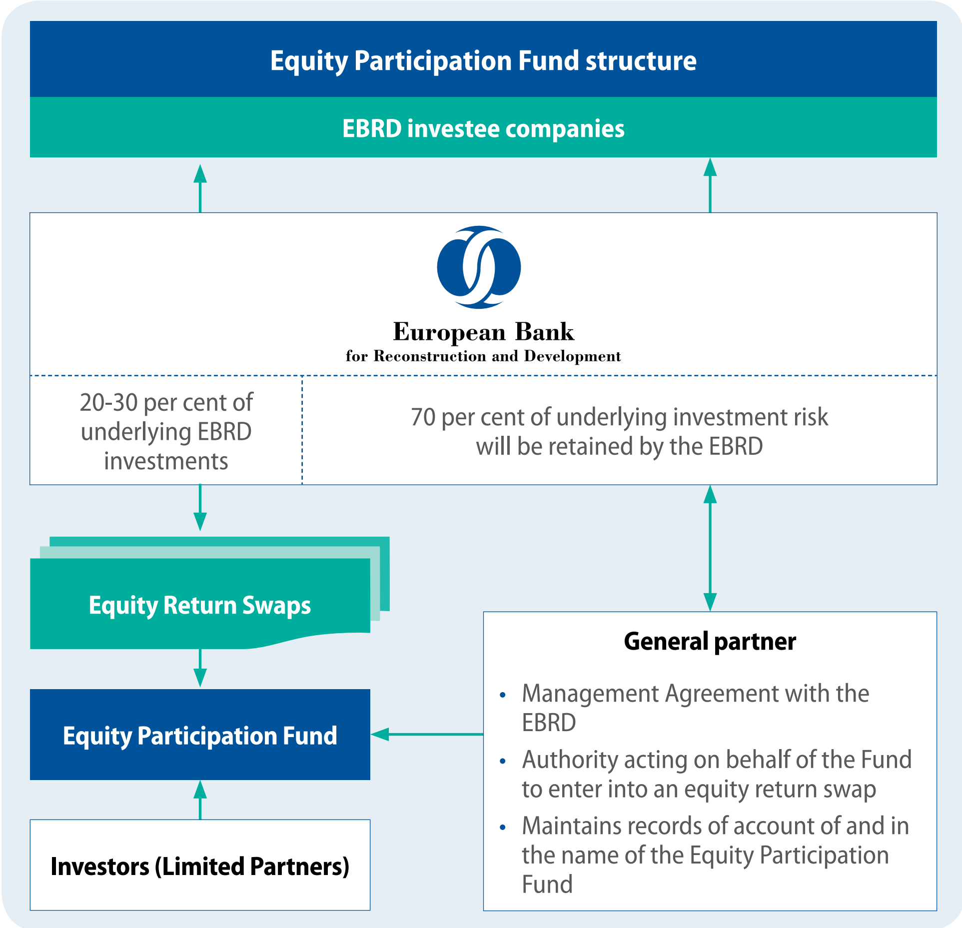
The Equity Participation Fund had a target size of €750 million to €1.5 billion, about 50 target investments of €10-100 million, an investment period of five years and a life of 10-12 years. It would comprise direct equity investments (excluding debt, portage, publicly listed securities and PEFs), which would be sourced from new investments, and possibly up to 25 per cent of existing investments. Investors in the Equity Participation Fund would have an economic interest but no title in the assets. The geographic selection of direct equity would determine the risk profile. There was potential to offer up to 50 per cent of central Europe and the Baltic states and exclude southern and eastern Mediterranean region investments.

The size of the Equity Participation Fund could be at least €750 million, assuming minimum direct equity Annual Bank Investment during the five-year investment period of €500 million and a 30 per cent overall participation ratio. If the fund was seeded with up to 10 per cent of the current unrealised portfolio of €4.7 billion, then the fund size could reach €1.5 billion. The Equity Participation Fund would be structured as an English limited partnership, the GP would be an English limited liability company, owned 100 per cent by a third party administrator. The GP would appoint the EBRD as the fund manager, reimbursed by a direct fee with no carried interest. Investors would participate as limited partners under the terms of the fund, by investing in equity participations from the EBRD structured as equity return swaps. The limited partners would be passive, following the EBRD investment process. Within the EBRD, there would be an Institutional Investment Partnership team, a Steering Committee and an Oversight Committee that reported to the Executive Committee. The formal launch of the Fund was targeted for 1H 2015.

In 2015, the indicative size of the **Equity Participation Fund** was reduced to €250-750 million, with a

3 Management noted it was also looking at a Loan Participation Fund, but that this would be developed under a separate initiative.

FIGURE A1. PROPOSED STRUCTURE OF THE EQUITY PARTICIPATION FUND



Source: EBRD (2015d)

minimum first close of €250 million and a target portfolio return of 15 per cent. An option was provided to redeem the outstanding equity return swap at fair value through a liquidity redemption facility at the end of the Fund's life from year 12. This feature was key to the **Equity Participation Fund** structure, because it does not directly hold the shares of the underlying investee companies, and there is no secondary market for the equity return swap that is linked to the residual illiquid investments, which the Bank is unable to exit from within the minimum expected lifetime of the Fund. The redemption facility would be based on a sweep that would take place after year 12 and be offered for a three-year period from 2027 to 2030. The price would be based on the EBRD prevailing estimate of fair value at that time. If there were any remaining equity return swaps after year 15, then the Bank would have a right to call for all remaining equity return swaps to be redeemed at their prevailing fair value. The residual risk was expected to be limited, as the EBRD direct equity investments are mostly planned to exit within 10 years.

The GP would be a signatory to the executive body of the **Equity Participation Fund**. The EBRD would have effective control over the GP, and it would appoint one member to the board of directors of the GP. The other directors of the GP would be professional nominee directors. The EBRD would act as the manager of the Fund, and it would appoint an external fund administrator to support administration and investor reporting. The fund administrator would implement industry standard systems and provide investors with access to the Fund's data.[4] The EBRD auditor would be responsible for auditing the Fund's accounts. A limited partners advisory board would be established, which could not influence the investment process of the EBRD or the **Equity Participation Fund**, but would provide a mechanism for engagement with the EBRD and a platform for future co-investment.

In its capacity as fund manager, the EBRD would appoint an **Equity Participation Fund** management

4 Aztec Financial Services (UK) Limited was selected after a competitive selection process.

team and implementation team. A dedicated **Equity Participation Fund** team, reporting to the Managing Director of Equity, would be created to provide fundraising, administrative, internal liaison and investor relations support, including the Limited Partner Advisory Board. An **Equity Participation Fund** implementation team, with staff drawn from equity, risk, finance, equity operations, the EPMU, the office of the secretary general and information technology would oversee actions prior to first close, such as preparation of the Private Placement Memorandum, the limited partnership Agreement and the Fund Administrator Agreement, and their approval by Management and the Board. The costs of the **Equity Participation Fund** for the EBRD would be recovered through an annual management fee.

Investor feedback on the structure and EBRD participation was positive, but there were concerns about the region selected. The EBRD had good access to investments and could mitigate political, financial, integrity, environmental and social risks in the region, extensive experience, and a diversified portfolio on a country and sector basis; there were also further co-investment opportunities. Offsetting these factors, there was decreased appetite in emerging markets, particularly in the countries of operations. For several institutions, central and eastern Europe and the southern and eastern Mediterranean were outside their investment mandate, and some institutions wanted to be able to pick and choose countries. A 15 per cent target return was seen as too low; the EBRD transition objectives were not seen as consistent with profit objectives; the lack of carried interest reduced the EBRD's management incentives to generate returns; and the EBRD's role as a minority investor meant it was seen as being passive, rather than active, value creation.

The first close of the **Equity Participation Fund** was targeted for December 2015/Q1 2016, with a €250 million commitment from the People's Bank of China and the State Administration of Foreign Exchange of China, which had already established loan co-investments funds with the IFC (US$3.0 billion), the Inter-American Development Bank (US$2.0 billion) and the African Development Bank (US$1.0 billion). On 19 September 2016, the EBRD completed €350 million first round fundraising for the **Equity Participation Fund**. The investors were the State Administration of Foreign Exchange and the State Oil Fund of Azerbaijan.[5]

5 This investment followed the People's Republic of China joining the EBRD as a non-borrowing shareholder in January 2016.

A1.4.3. The Enhanced Equity Approach

The Enhanced Equity Approach was introduced in 2016 by Management to reflect the importance of equity to the EBRD operations, coupled with an acknowledgement that the financial performance of equity had been less than expected in recent years. Management noted that an analysis of the EBRD historical financial performance confirmed that transition was well correlated with the financial returns of equity investments, supporting the EBRD approach of sound banking principles, although there was a need to build an equity culture and create a relevant incentive mechanism.

The presentation to the Board introducing the Enhanced Equity Approach noted that the EBRD's returns on direct equity were below expectations due to external factors (e.g. geopolitical events, market volatility, foreign exchange impacts) and internal factors (e.g. a lack of specialised processes and accountability, poor timing of entries, approach to exits, value creation plans that were not properly implemented, a lack of appropriate incentives). This list broadly reflected a prior analysis prepared by Management in 2014 that noted such issues as the declining number of equity deals, the lack of a clear equity strategy and limited budgets for due diligence.

Management proposed to the Board that the EBRD should develop a new equity platform – the Enhanced Equity Approach – that could draw on its historical strengths with direct equity and funds. The Enhanced Equity Approach is based on two pillars: (a) creating an internal enabling environment for equity investments; and (b) having a clear investment policy based on the Enhanced Equity Investment Guidelines.

Pillar 1: Creating an internal enabling environment for equity investments

The Enhanced Equity Approach ensures separation between equity and debt, while emphasising the need for a focused approach to value creation. Under Pillar 1, the first step in the reform process was the integration of direct equity, PEFs, the **Equity Participation Fund** and EPMU activities within a single **Equity Group**. This step was taken in 2014 and, between then and 2016, the number of bankers in the **Equity Participation Fund** increased from 11 to 19.

In December 2015, the Executive Committee approved a proposal for the Equity team to take responsibility for the direct equity portfolio and to be responsible for the value creation of the entire equity portfolio. The Equity team would act as transaction execution advisors to an **Equity Network** of 17 bankers from key country and sector teams, who would work on a mix of debt and equity transactions.[6] These bankers would act as the operating leaders on each equity investment, including the existing portfolio, with responsibility for value creation over the whole lifecycle of the equity investment, from structuring through to portfolio management and divestment.

The initial intention was to expand the country coverage of the network over time, and increase the level of specialisation of bankers in managing equity. Management aimed to meet PwC's recommendation to conform to industry norms of an average of six deals per dedicated equity specialist (compared with the current level of 11.2) by the accelerated exit of small investments in 2016, increasing the size of investments and some staff reallocations. Expanded training programmes on equity would be provided to staff. The interests of Equity team and Equity Network members would be fully aligned, achieved through the introduction of scorecards that included clear key performance indicators linked to IRRs and money multiples that were achieved over time through value creation plans covering actions such as the timing of exits.

Going forward, there was an intention to establish a Value Creation Leaders' Unit by July 2016 that reported to a new Deputy Head of Equity, who would be accountable for portfolio performance. Under this new arrangement, the Equity team would allocate existing senior bankers to new portfolio manager roles as Value Creation Leaders. These would be responsible for ensuring that value creation was occurring for each investment in their portfolio, and they would mentor the allocated Equity Lead for each investment. Value creation plans would be prepared for all new investments, and regularly reviewed and updated. The Equity team scorecard would be finalised in 2016 and would include parameters on expected profitability, value creation and exit targets. **Nominee directors' procedures**, relating to the selection and appointment of EBRD nominee directors and members of Equity Fund Committees, were updated and approved in February 2016. There would continue to be be regular reviews of nominee directors' performance against targets.

6 The country and sector teams are already present in Egypt, Poland, Romania, Russia, Serbia and Turkey.

The EPMU's role would be strengthened under the Enhanced Equity Approach. It would maintain its responsibilities of acting as Secretariat for the **Equity Committee**, and continue to have responsibility for administrative matters (such as coordinating the fair valuation reporting process, maintaining databases and preparing reports, including new value creation and key performance indicator reports). The Bank was investigating ICT systems that could assist in building an equity culture and make the handling and management of equity investments more efficient. A system to capture clients' financial statements was expected to be completed by the end of 2016, and a monitoring and value creation system was expected to be implemented by December 2017.

Equity Risk was established in 2015 and was seen as a key step towards creating an equity culture within the EBRD. An **Equity Forum** was created at the same time, comprising members of the Equity Group and Equity Risk, who would be required to review early-stage proposals and allocate promising leads to the Equity Network bankers.

The Operational Committee is responsible for reviewing and approving equity investment proposals. To help avoid potential conflicts, it has agreed to **sequence its agenda** into separate sessions for debt and equity. The Operational Committee expanded the role of the **Equity Committee** mandate to cover all equity portfolio aspects, by delegating all responsibility for exit decisions (under the previous arrangement, the **Equity Committee** could make exit decisions only on listed equity investments) and **Equity Participation Fund** portfolio reviews.

Pillar 2: Having a clear investment policy based on the Enhanced Equity Investment Guidelines

The Enhanced Equity Approach policy provided a vision of how equity investments would be structured and the portfolio managed over time. There was an intention to develop more co-investment opportunities with PEFs, and introduce a more rigorous approach to defining the risk-return profile of the portfolio by defining concentration limits for equity investments by country, sector, single client and instrument (mezzanine, direct equity and equity funds). Typical equity investments were expected to range from €25 million to €100 million and there would be an exit after four to seven years. Equity investments would be made in all of the EBRD's regions, although concentrations were expected to be larger in economies and regions with high potential (e.g. the Balkans, Egypt, Morocco, Poland, Romania, Russia, Turkey and Ukraine).[7]

Projects would comply with the EBRD transition impact, additionality and sound banking principles, and align with thematic pillars such as energy efficiency, environmental and social guidelines, and gender inclusion. The EBRD would aim to invest counter-cyclically throughout the economic cycle, rather than having fixed annual volume targets. The overall return expected from investments in the **Equity Participation Fund** would be different from the EBRD overall portfolio, as it would only include projects above €10 million in investment size, and exclude funds and some mezzanine investments. It was proposed that financial returns remain within clearly defined risk-adjusted target return ranges by sector for the equity portfolio, with effect from 1 January 2016 and based on rolling three-year averages. Equity performance would be tracked on a yearly basis using selected regional market indexes as benchmarks.

7 Following the guidance of the EBRD's Board of Directors, the Bank is not undertaking new projects in Russia at this time.

Annex 2. Review of previous EBRD equity evaluations

This annex provides a summary of relevant evaluations prepared by the EvD. They cover key investment vehicles including:

- the Regional Venture Funds programme in Russia (evaluated 1997)
- post-privatisation funds (evaluated 2001)
- the Direct Investment Fund (evaluated 2001, 2006 and 2008)
- the Private Equity Co-investment Facility (evaluated 2011).

Source documents for the studies are provided in the Reference list. If no source document is given, the study was internal and unpublished.

A2.1. Mid-term review of the Regional Venture Funds programme in Russia (1997)

The Regional Venture Funds were introduced at the EBRD in 1993 to facilitate modernisation, expansion or restructuring of privatised enterprises by providing new equity capital with technical support. They were closed-end equity funds with a 10-year life. As part of this review, the EvD visited five of the 11 funds operating in Russia at that time. Under the programme, the EBRD provided each fund with ECU24 million for equity investments, which was complimented with external donor-sourced technical cooperation funds. The time horizon for each Fund was 10 years, and the entire programme was scheduled to run from 1994 to 2006.

The study concluded that the programme generated substantial transition impact, but at substantial cost (which could not be readily quantified). Disbursements had lagged behind expectations due to the difficult environment and lack of venture capital expertise. It was not possible to determine the expected profitability and a follow-on review was proposed to address this at a later date. It recommended that the management and administration of the programme should be transferred to a specialist venture capital management company, and the funds should be established as independent legal entities.

A2.2. Review of five post-privatisation funds (2001)

The five funds involved committed capital of €186 million, of which €140 million was sourced from the EBRD, located in in the Baltic states, Bulgaria, Kazakhstan, Romania and Slovakia. The funds targeted medium-sized enterprises and investments in the range of €300,000 to €3 million. They were administered by professional fund managers and supported by substantial technical cooperation grant funding. Additionality was acknowledged, as there were few sources of equity in the region. Overall, the funds were rated partly successful, while their transition impact was judged marginal. After an average of four years of operation, only 49 per cent of the capital was disbursed, and it was too early to assess financial performance.

The experience of these five post-privatisation funds indicated that post-privatisation financing was not an appropriate target market for an investment fund vehicle. In many cases, privatisation transactions were not sufficiently transparent to produce enterprises with an adequate governance structure. In addition, after the privatisation process was launched, it was completed quite rapidly and the funds then refocused on existing private companies. Looking more generally at the potential of venture capital investment funds as instruments for equity funding to medium-sized enterprises in transition countries, the study suggested that second-generation funds in relatively advanced transition countries would need to increase the amount of total funding and average deal size.

The minimum economic size of the funds is an argument for regional, rather than country-based, vehicles targeted at a geographically diversified market. Larger funds (and larger deals), driven by commercial considerations, would weaken the case for a high level of donor support. In addition, second-generation funds would need to be structured as conventional fund vehicles, rather than as managed accounts. The scope for first-generation PEFs in earlier transition countries was limited.

No earlier transition countries – other than those served by existing Post Privatization Funds – have sufficient economic size or adequate governance structures to support a substantial volume of private equity investments (and exits). As a result, the potential level of interest among professional fund managers to operate in these countries was low.

A2.3. Evaluation of the Direct Investment Fund (2001)

The Direct Investment Fund was approved in 1998 to test direct private equity investments in SMEs in low transition countries, and the pilot phase was ongoing at the time of evaluation. Exits were targeted in three to five years for minority stakes of US$0.5-2.5 million. Project preparation was undertaken by regional offices, and headquarter staff were overseen by an internal Fund co-ordination unit. Project approvals under the Fund were referred to the Deputy Vice President of Banking. Large technical cooperation grants helped to garner support from finance sector and legal specialists. There was limited post-investment involvement.

The evaluation rated the Direct Investment Fund successful based on potential high transition impact. The study confirmed the relevance of the Fund concept of targeting SMEs in earlier transition countries, but noted that risks were high and there was a need for diversification in more advanced countries to contain these risks. This diversification diluted the impact of the Fund portfolio and compounded the effects of slow disbursement. Transaction costs were high; they could account for 20-25 per cent of total investment costs by the time of signing, and could double during the operating period until exit. The limited availability of staff with private equity skills was a significant constraint.

The study recommended that the approach to risk management should be clarified to determine if the Direct Investment Fund approach of using a portfolio approach to manage risk on venture capital was more appropriate than a credit-orientated, project-by-project outlook on risk. Similarly, it recommended that explicit clarification should be given as to whether risk balancing within the Fund was expected, or if risk sharing with the Bank's total portfolio was implied. It was noted that the Bank's organisation is geared towards other types of deals, and lacks an equity culture. The sector teams could provide only intermittent support to labour-intensive SME equity projects. This capacity conflict would increase as problems inevitably emerged later on.

The evaluation concluded that to operate in the longer term, the Direct Investment Fund needed more tailored capacity, career paths and performance incentives, looking to universal fund management principles. The recently strengthened coordination unit for the Fund could form a first step towards designated central capacity to support work in fewer selected regions. An internal investment committee should be considered, to operate in accordance with common fund-management practices.

A2.4. Follow-up evaluation of the Direct Investment Fund (2006)

In 2004, the Direct Investment Fund was transferred to the Early Transition Country Initiative team and allocated additional resources. Due to a deterioration in the Fund portfolio, a new Early Transition Country committee had been established; quasi-equity instruments were introduced to enable early exits of problematic investments; untested technologies were avoided; there was increased use of external board nominees; and greater availability of untied technical cooperation funding under the Early Transition Country Multi-Donor Fund. The EvD did not rate the success of the project, as it was still evolving, but noted the capital value was 80 per cent of original cost, and the costs of operating the Fund were substantial.

The evaluation also noted that, in addition to these direct costs, there was the negative demonstration effect of ongoing losses; the Bank's reputational risk derived from assuming the directorships of companies whose business conduct might not be totally transparent; and the typical lack of exit opportunities through emerging equity markets, which threatened the realisation of transition impact objectives. It was observed that institutions such as the IFC and the Commonwealth Development Corporation were no longer pursuing direct SME private equity in these types of environment, and that a review of the future of the Direct Investment Fund should be undertaken by 2008.

The study recommended, inter alia, that costs of operations should not be ignored when reporting on performance; consideration should be given to recruiting more senior staff with business and equity management experience; the structuring of put options on the investee companies should not be encouraged; and conversion to debt instruments should be pursued, while containing the use of overly complex structures, modelled on private equity in developed markets.

A2.5. Follow-up evaluation of the Direct Investment Fund (2008)

Despite 10 years of operation, it was still not possible to confirm transition impact, as the Direct Investment Fund had not been able to provide demonstration effects of a successful private equity cycle. Additionality was confirmed, and financial performance was reported to have improved significantly since 2004, although overall, a loss of €21.75 million was incurred. It was noted that there were opportunities to improve bank handling of the operations, but these were not seen as a constraint on performance.

Overall, the project was rated as successful. There were several recommendations, of which the most important were to expand the role of the Early Transition Country Initiative's Investment Committee to include the review of ongoing monitoring reports, the approval of exit recommendations, and preparing profit and loss statements for the Direct Investment Fund.

A2.6. Private Equity Co-investment Facility (2011)

In **2011, the EvD evaluated the Private Equity Co-investment Facility**, which was established in mid-2000 with an initial budget of €73.5 million. The purpose of the Facility was to enable the EBRD to execute co-investments below €10 million quickly on a pari-passu basis (equal seniority or rights of payment) with PEFs. This initially consisted of EBRD clients, but was later expanded to include non-clients. The Facility was intended to leverage existing EBRD investments in PEFs and reach out to new companies in search of equity financing. The rationale for creating the Facility was to address the operational priorities of equity, wholesale approach and SMEs. The EBRD targeted PEFs to benefit from their unique deal-sourcing and investee-management abilities. By the end of 2009, following two extensions and an increase in the Facility's budget to €164 million, the EBRD had invested through the Facility an aggregate of €96.8 million in 14 sub-projects alongside PEFs, of which six had been exited.

The operational and financial performance of these sub-projects was mixed. The **Private Equity Co-investment Facility** was relevant, but effectiveness was weak. Almost all of the projects were made within the EU, as this was the region targeted by PEFs. In most cases, the PEFs preferred to target large deals; only three out of the 14 sub-projects targeted SMEs. The six fully realised projects returned an IRR of 20.8 per cent, which was very close to the return targeted for the Facility at approval (21 per cent). By comparison, based on the valuation of the eight investee companies at June 2010, the unrealised portfolio of the Facility registered a negative gross IRR of –3.8 per cent. Only 50 per cent of the Facility budget was utilised.

The PEFs' potential impact on SMEs was the main rationale for the participation of the EBRD. The EvD's previous reviews of transition impact indicated that it was relatively insignificant. The EvD concluded that due to the limited sample and the age of the investments reviewed (all approved by the Board before 2001), this review did not reflect the current impact of the Bank's PEFs on SMEs.

A2.7. Mid-term review of EBRD investments in equity funds (2002)

The study (EBRD, 2002) noted that the EBRD had 10 years of experience investing in PEFs and was the leading investor in the Bank's countries of operations. It had over 70 funds under 55 managers, which together held joint capital of €5.2 billion, of which €1.5 billion had been committed by the EBRD. Close to 50 per cent of the EBRD's commitments in US dollar terms were allocated to 'expansion/buy-out' funds, with average stakes of about €6 million in medium-to-large private enterprises.

Donor-supported funds accounted for about 33 per cent of PEF investments, and focused on smaller holdings in less advanced transition environments. Donor-supported funds had an SME focus, with many venture capital funds that had average stakes below €2 million and represented about 17 per cent of the Bank's commitments. Within the total commitment of €1.5 billion in equity funds, by the end of March 2002, €52 million was disbursed. There had been steady growth in EBRD investments in equity funds, reaching a gross level of between US$300 million and US$400 million per annum, with the bulk of this investment occurring in the period 1999-2001.

The review found that transition impact via these funds was closely linked to financial returns and, in practice, transition impacts were closely linked to financial objectives. When the EBRD selects funds as intermediaries, it must accept that the management of these needs to be driven principally by return prospects within the given strategy. Operational intervention beyond strategic and standards conditions would risk compromising the incentives and efficiency of the market-driven instrument.

Funds that took larger stakes in medium-to-large enterprises in the advanced parts of the region were found to have the best prospects. Conversely, investments in SME funds and funds in low-reform environments saw the transition impact suffer from a lack of sustainability. The fund instrument – whether donor supported or not – was found to present excessive goal conflicts for many of these investments, particularly in areas such as time-bound exits. There were hardly any IPO prospects on any stock markets for these small stakes, few trade sale opportunities to local buyers, and the small stakes had limited attraction to foreign investors.

The amounts invested by the PEFs were minute compared with the needs of the region, and the transaction costs of establishing and managing the funds were high. The review found that fostering an equity fund infrastructure could attract international and, ultimately, domestic investors, and there were signs of fund managers raising multiple funds in Russia and central and eastern European countries. Financial returns were mixed, with larger expansion/buy-out funds creating the best returns. Venture capital funds and donor-supported funds had demonstrated poor to fair results due to low exit rates. The evidence was clear: that most stakes under US$2 million were difficult to sell at a profit. Overall, it was difficult to determine expected performance, as there were insufficient exits and the region lacked stock exchanges with well traded stocks and valuation benchmarks.

The review recommended there should be no new SME investments via PEFs in low- and slow-reforming transition environments, where the issues of high operating risks and poor exit liquidity were too great for the fund instrument to meet transition impact and financial sustainability objectives. Instead, the EBRD should continue channelling debt in collaboration with local banks and institutions. The review considered organisational options within the EBRD for managing the PEF operations. These ranged from outsourced or 'joint-venture' operations to an expanded and further specialised in-house PEF team. Due to constraints on outsourcing, it was concluded that further specialised in-house capacity should be developed, with a long-term objective to spin-off parts of the portfolio. This would entail splitting the PEF portfolio into three sub-portfolios: (a) more mature economies and companies, with experienced fund managers or second-round fund raisers; (b) the higher-risk, SME-orientated funds in central and eastern Europe; and (c) PEFs in advancing, intermediate transition environments.

In this way, the EBRD could prepare to transfer some PEF activity to a separate fund investing in existing funds (fund of funds) for mature transition environments, with private investor participation and/or the ultimate sale of some parts of the portfolio on secondary markets. The internal PEF team should be consolidated into a more specialised unit, with its own career paths and incentives for staff. There was a case for designated work-out/close-monitoring capacity. The Bank could consider converting the current informal committee within the PEF team into a formalised Investment committee for PEF activities. It could also refer to the practice, found in some funds of funds, of joining key team professionals with one or two external experts to add fresh perspectives and networks.

A2.8. Performance review of private equity fund operations (2007)

The EvD rated the nine funds under review as successful. The review noted that pre-1999, the EBRD mainly supported first-time fund managers that were new entrants to the industry. That approach supported a process of industry development that could have led to a more competitive market structure in the fund management industry, although in practice, a stable oligopoly had emerged. The review concluded that private equity was readily available in central Europe and, in the future, the EBRD would need to seek more unique funds such as start-ups or the funding of the fund managers themselves.

A2.9. Evaluation of equity exits (2009)

The EvD reviewed 39 exits over the period 2004-05. These investments had been held on average for a period of three to five years and had generated an IRR of 12.6 per cent before funding and direct costs. This result was towards the bottom end of the expected range of target returns, but broadly consistent with market comparators. The report examined whether the

EBRD was disadvantaged at exit, as a minority investor alongside a strong sponsor where the sponsor is the likely buyer of the Bank's interest. It also considered the pricing basis on exit, and the risk of possible dampening of performance figures by investee management to suppress the exit price and the effective structuring of put options.

Findings were generally supportive, stating that the EBRD's position was safeguarded to the extent possible. About 54 per cent of the projects generated transition impacts that were satisfactory or better, although this was below the Bank average. About 30 per cent of the full exit sample reviewed delivered at least an adequate level of both transition impact and financial returns. However, in most cases, expected transition impacts were not clearly documented, and the justification for using equity relative to other financial instruments was not a requirement of the EBRD's operating procedures. Exit strategies were not clearly articulated, with more than 60 per cent of the cases citing an IPO as the exit strategy, and in none of these cases was this implemented. Evidence suggested a lack of management post-investment approval, and in many cases the basis for the timing of exits was not clear.

The report highlighted areas where the EBRD's equity practice could be strengthened. Investment management should focus on value creation, the engagement of the **Equity Committee** should be expanded, or a special-purpose private equity investment committee should be established. The scope of equity information in management reports circulated to the Board should be expanded to give more visibility and transparency to equity investment performance, both financial and transition impact. The formats for Exit Approval Memoranda and subsequent Exit Information Notes to the Board should be revised to include explicit statements of the level of fulfilment of financial targets and transition impact objectives.

The report also identified numerous opportunities to enhance operational practice, grouped into the three investment stages: entry, post-investment and exit. These initiatives included the introduction of hurdle rates, an enhanced link between the equity instrument and transition impact, stronger exit strategies and monitoring and reporting.

A2.10. Achieving equity investment objectives: a review of initiatives since 2007 (2014)

This study (EBRD, 2014a) considered the extent to which management addressed issues identified in the EvD equity exits study of 2009, and whether there were areas for further improvement. A secondary objective of the study was to identify the extent to which the EBRD was defining equity operations objectives in a way that was specific, measurable and amenable to post-investment monitoring.

This study was prepared in the context of a review by Management on ways to strengthen the portfolio's management function, including equity (see Annex 1). Much of the direction of development in the way equity was managed flowed from the findings of a 2009 working group to review operational capacity-building. The working group identified an absence of focus on value creation in equity management, and the challenges of dealing with multiple management processes bolted on to a debt-orientated monitoring approach, as important constraints. Its recommendations included redefining and resourcing the position of Managing Director, Portfolio Business Group, with a major focus on post-investment equity management to ensure the Banking Department follows up on equity issues. The working group identified issues including the need for a reorientation of equity management processes, and tools to support a value creation objective.

The study found that the management framework for equity investments had improved significantly since 2009. The **Equity Committee** now had basic data requirements, and it was supported by the Office of the Chief Economist and the EPMU, which had recently been established. The Accounting Frameworks Limited management system had been commissioned to provide data for analysis, to support a more structured approach to managing the equity portfolio. The EPMU was strengthening valuation models and preparing quarterly risk reports. It was also in the process of developing new report formats to be used in project preparation and monitoring, based on updated equity term sheets, company value creation plans and a value creation key steps annex. These new formats were expected to provide a clearer definition of value creation opportunities, actions and objectives at all stages of the project lifecycle, and bring greater clarity to the performance of equity investments.

The study endorsed these findings, but noted that the equity approach lacked a clear emphasis on value creation from pre-investment to exit, and it was undermined by the monitoring report structure. Monitoring reports and the Project Monitoring Module were not fit for purpose, and a redesigned approach was required to monitor equity. The investment process did not define expected equity results ex ante in an integrated way across the EBRD (i.e. linking the related dimensions of returns, risk and transition).

The study focused specifically on an assessment of transition impact, value creation and risk management. It concluded that improvements in corporate governance and shareholder interaction had been the EBRD's primary rationale for equity investment, and it gave particular attention to the effectiveness of the corporate governance approach in achieving transition impact through equity value creation. The evidence from the sample review indicated there was an insufficient understanding in EBRD documents of governance and the influences on its effectiveness. Analysis of governance factors was sparse, and the formal setting of specific objectives for nominee directors was not common practice. There was no ex ante analysis of governance issues presented in approval documents, which meant it was unclear which gaps need to be filled or issues addressed and reflected in transition impact benchmarks.

The study further noted that the corporate governance due diligence checklist, which was being developed in 2014, could potentially provide a basis for improved assessment and gap analysis, and establish the basic principles of governance expected by the EBRD. It was not clear, however, how value creation was linked to traditional Bank indicators such as transition impact, additionality or bankability.

With regard to risk management, the study found that Management consistently underestimated the average life of an investment, and many project risks were not adequately recognised in monitoring reports. Project risk analysis had improved and operational risks were included more frequently in project board approval reports than the previous evaluation. However, significant gaps remained, including: (a) political and regulatory risk assessments were often limited, even though they clearly had a major impact in many cases; (b) key operational risks, such as people risk, systems development and compliance, were not presented; (c) the description of risk mitigation was often an explanation of why a risk was not relevant, rather than a description of what would be done to address the remaining risk; and (d) risk profiles and key risk indicators were not used. The findings of the risk analysis were not factored into the size of the discount rate and the valuation of equity. There was evidence that the Credit Department's concerns were not adequately addressed in documentation, it was unclear how exit horizons were factored into pricing, and there was limited sensitivity or scenario analysis.

On the basis of this analysis, the study recommended that there should be a review of: (a) the business process for equity investment, so that it supported the objectives of value creation and transition impact; (b) the monitoring process to ensure reports, which should clearly define the objectives that will be monitored; and (c) the board document template, which should incorporate equity-specific elements in its format, providing details on value creation plans and enhanced corporate governance approaches, expected transition impacts and financial risks and returns.

Management responded to state that it was already implementing an equity approach review to identify how it would monitor equity credit in the broader context of the Bank's operations. The review would consider how monitoring reports could be updated to provide additional details in areas such as the assessment of exit routes and analysis of risks.

Annex 3. Review of equity programmes at other international financial institutions

A3.1. Overview

In recent years, the EBRD has invested about €750 million to €1.2 billion per annum in direct equity and PEFs. This figure is relatively low when compared with IFIs such as the IFC, which invested about €3.0 billion per annum from 2010 to 2013. When compared with other IFIs, equity was a small, although growing, proportion of the EBRD operations; see Table A1.

Similar to the EBRD, the German Investment Corporation, the Netherlands Development Finance Company, the IFC, the European Investment Bank and the European Investment Fund can invest directly in both equity and PEFs. Many of these IFIs have been following a range of co-investment strategies to gain institutional investor support for sustainable, long-term co-investment, for example by establishing pooled equity and debt co-financing platforms for institutional investors.

A3.2. Overview of different IFI equity operations

A3.2.1. The International Finance Corporation

The IFC's investments in equity cannot exceed 25 per cent of a company's total capitalisation, and it does not take control positions. The IFC has been able to generate considerable value through first-mover advantages in emerging markets, and adding value by providing specialist expertise in areas such as governance, country and sector knowledge, financial structuring and various financial products. The IFC has also partnered with the World Bank to improve laws and regulations that enhance the enabling environment for businesses.

In 2009, the IFC established the Asset Management Company to enable institutional third parties to invest capital in selected IFC transactions. The Asset Management Company formed a third arm of the IFC's operations, alongside investment (direct financing) and advisory services. The Asset Management Company is a wholly owned subsidiary of the IFC and, in 2016, it had US$9.1 billion of assets under management through eight independent funds. The IFC is responsible for sourcing projects and conducting preliminary due diligence. The Asset Management Company and the IFC then jointly structure and negotiate prospective investments.

The Asset Management Company retains the freedom to make independent decisions on its investments, via the respective fund investment committees. It then coordinates with the IFC on commitments, disbursements, portfolio management and exit. The Company's board includes the IFC Chief Executive Officer; otherwise, governance arrangements are independent of its parent.

A3.2.2. The Netherlands Development Finance Company

The Netherlands Development Finance Company invests risk capital in companies and financial institutions in developing countries. It is one of the largest bilateral private sector development banks in the world, and it has a triple-A rating from Standard

TABLE A1. SCALE OF THE EBRD EQUITY OPERATIONS

Institution	Equity as a percentage of annual business investment (%)			
	2010	2011	2012	2013
EBRD	**13**	**13**	**12**	**15**
German Investment Corporation	28	42	38	39
Netherlands Development Finance Company*	n/a	n/a	26	30
IFC** (Asset Management Company)	25 (2)	20 (4)	18 (3)	19 (4)
European Investment Bank European Investment Fund	1	2	3	2

* Results are inclusive of mezzanine investments that contribute around 50 per cent to total equity volume.
** IFC figures include equity commitments of IFC Asset Management Company (AMC)

Source: EBRD (2014c)

and Poors. Although 51 per cent of its shares are held by the Government of the Netherlands and it has a development mandate, the Company operates as a commercial company. As a result, its return on investment is not just financial; it also seeks positive environmental and social impacts.

Due to its relationship with the Dutch government, the Netherlands Development Finance Company is able to assume risks which commercial financiers are not prepared to take. It has partnered with a number of firms, such as Fairview Capital, to invest in PEFs in developing countries in Africa, Asia and Latin America.

A3.2.3. The German Investment Corporation

The German Investment Corporation is a subsidiary of KfW, a German government-owned development bank. It finances investments of private companies in developing and emerging economies. In 2013, the Corporation's portfolio was around €8 billion, of which over 40 per cent was risk capital finance, which was broadly divided into mezzanine (debt) financing (20 per cent), direct (minority) equity in companies (10 per cent) and equity in funds (10 per cent) (German Investment Corporation, undated). The Corporation's regional focus is Africa, Asia, Latin America and central, eastern and south-eastern Europe. It provides a full range of services, including advice, guarantees, debt, mezzanine finance and equity.

A3.2.4. The European Investment Fund

The European Investment Fund was established in 1994, and it is an EU agency for the provision of finance to SMEs. The Fund does not lend money to SMEs directly, but provides finance through private banks and funds. Its main operations are venture capital and loan guarantees.

The European Investment Fund shareholders are: the European Investment Bank (62 per cent); the EU represented by the European Commission (29 per cent); and 30 privately owned EU financial institutions (9 per cent). It is a participant in the European Fund for Strategic Investments, which is an initiative launched in 2015 jointly by the European Investment Bank Group and the European Commission to help overcome the investment gap in the EU by mobilising private financing for strategic investments. The European Fund for Strategic Investments is financed with a €16 billion guarantee from the EU budget, complemented by €5 billion allocated from the Investment Bank's own capital.

The EU pursues several other programmes, including the Connecting Europe Facility, the European Infrastructure Package and the Project Bond Initiative, where guarantees and loans are used to mobilise private investment in infrastructure, including equity.

A3.2.5. The Commonwealth Development Corporation

The Commonwealth Development Corporation Group plc was established in 1999 as a development finance institution owned by the Government of the United Kingdom. The Department for International Development is responsible for managing the government's ownership interest in the Corporation. In July 2004, the Corporation divested its ownership interest in Actis Capital, the emerging markets PEF, with a 60 per cent stake being sold to the management team. The Corporation remained an active sponsor of Actis' investment activities, committing the equivalent of US$650 million to the firm's third fund in 2008.

Following an ownership reorganisation, the Corporation ceased to make direct investments and became a private equity fund of funds. In 2011, it implemented a new business plan, focusing its investments on the poorer countries of south Asia and sub-Saharan Africa, and once again decided to start providing direct investments to businesses alongside its fund of funds model. In November 2016, the UK government announced that it intended to increase the amount of support it can provide to the Corporation from GBP1.5 billion to GBP6 billion (*Financial Times*, 2016b).

A3.3 The Inter-American Bank comparative study of equity investment in development finance institutions

A3.3.1. Introduction

The Office of Evaluation and Oversight at the Inter-American Development Bank prepared a Comparative Study of Equity Investing in Development Finance Institutions (IADB, 2017). The institutions reviewed included:

- global direct finance institutions such as the IFC, the Netherlands Development Finance Company and the German Investment Corporation

- regional finance institutions such as the EBRD, the Asian Development Bank and the Development Bank of Latin America.

Table A2 summarises the main characteristics of their equity programmes.

The study found that direct finance institutions used the following rationales for equity investments:

- They support economically important, under-served investees.
- They help develop local equity markets by signalling opportunities.
- They support priority sectors and provide an understanding of private sector concerns.
- They foster the use of environmental, social and governance best practices.
- They generate financial returns.

The significance of these rationales varied across institutions, which had implications for the type of instruments used to achieve objectives (see Figure A2). For example, support to existing clients relies on direct equity, whereas stable financial returns rely upon a diversified portfolio of investments in direct equity and PEFs. Direct investments avoid the need to pay fees and other forms of compensation to fund managers, but require extensive investment in internal capacity-building and information systems. Direct finance institutions usually use direct investments when they can leverage some comparative advantage that compensates the higher costs of managing all the investment functions in house. Comparative advantages include existing relationships, local presence and sector expertise. Institutions often use direct equity investments in association with debt to help advance sector development goals, while PEFs represent a more passive form of engagement.

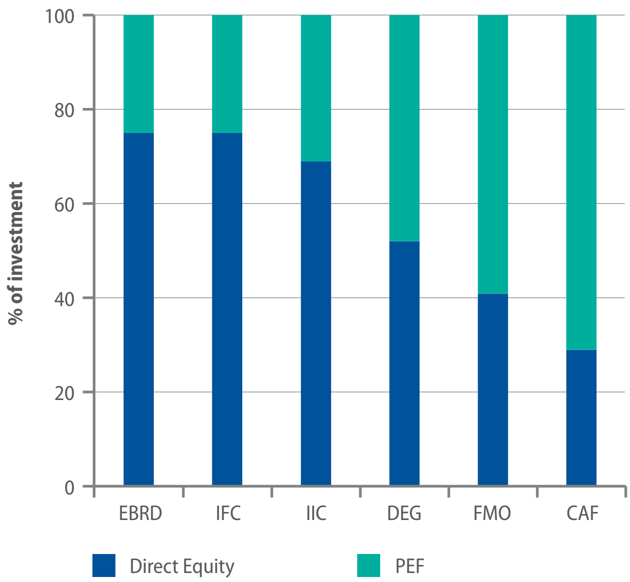
Direct finance institutions with a global presence have tended to have a higher share of equity in their portfolios due to greater opportunities for investment and diversification. The use of equity has also been related to their experience. Most institutions are loan-making and gradually began developing complementary equity programmes in the early 1980s. As they gained a track record, they increased their

TABLE A2. CHARACTERISTICS OF EQUITY PROGRAMMES IN SELECTED DIRECT FINANCE INSTITUTIONS

	Institution	Equity portfolio size (% of total portfolio)	Sector strategy	Geographic focus
Global direct finance institutions (DFIs)	IFC	US$13 billion (36%)	Mid-market-focused growth equity Supports infrastructure, climate change and SME funds Selectively supports small business funds in frontier regions	Africa, Asia, eastern Europe, Latin America, Middle East
	Netherlands Development Finance Company	US$1.6 billion (25%)	Strong focus on PEF investing, with an emphasis on financial institutions and energy	Africa, Asia, Latin America and the Caribbean, eastern Europe
	German Investment Corporation	US$1.3 billion (23%)	SMEs and mid-market equity investments focused on growth strategies Sector-agnostic: limited number of sector-focused funds	Frontier markets in Africa, Latin America and the Caribbean, eastern Europe, south Asia and south-east Asia
Regional DFIs	EBRD	US$5.6 billion (18%)	Strategy-agnostic: seeks to build a diversified portfolio	Central Europe, central Asia, north Africa
	Asian Development Bank	US$0.9 billion (16%)	Focuses on financial services, infrastructure, clean energy and agribusiness	Asia
	Development Bank of Latin America	US$0.39 billion (8%)	Strong focus on infrastructure and fund investing	Latin America

Source: IADB (2017)

FIGURE A2. DIRECT FINANCE INSTITUTION ALLOCATION OF EQUITY INVESTMENT BY TYPE OF INSTRUMENT



IIC = Inter-American Investment Corporation; DEG = German Investment Corporation; FMO = Netherlands Development Finance Company; CAF = Development Bank of Latin America.

Source: IADB (2017)

equity businesses. For example, according to financial statements, the IFC increased the share of its equity portfolio from 17 per cent in 1989 to 36 per cent in 2015. In 2009, IFC founded a wholly owned subsidiary – the Asset Management Company – to manage third-party funds.[8] This reflected IFC's increased strategic interest in equity and the credibility of its equity track record.

Most direct finance institutions (DFIs) have diversified investments across several sectors (see Figure A3). Financial services have played an important role in institution portfolios: they provide underserved populations with access to finance; they are inherently diversified; and they are regulated, thereby reducing risks. Investment in infrastructure has also been significant, as this is essential for development. Their participation is sought by the market as they provide a unique source of political risk mitigation.

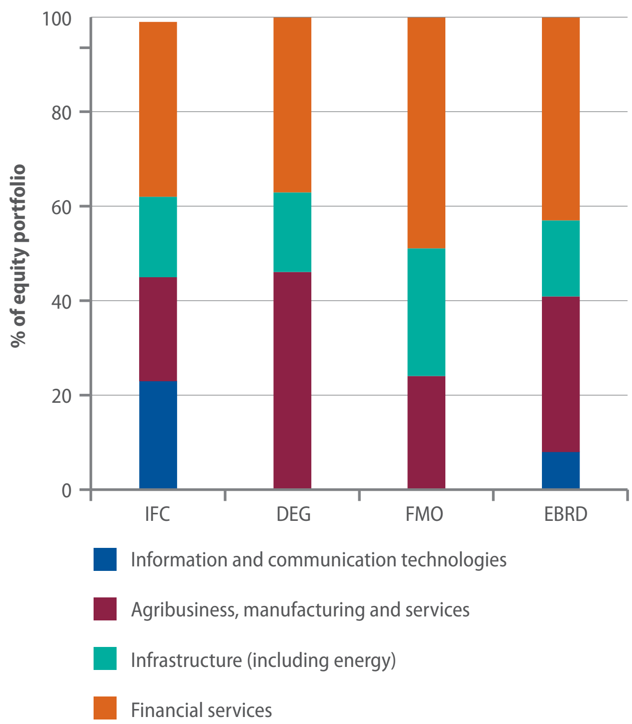
DFIs have achieved lower levels of geographic diversification (than sectoral), particularly at the regional level, and have tended towards having disproportionately large exposures in their largest member countries. For example, in 2015, Russia accounted for 21 per cent of the EBRD equity portfolio, and Mexico represented 31 per cent of the Inter-American Investment Corporation portfolio and 15 per cent of the Development Bank of Latin America portfolio.

Large countries tended to offer better institutional environments and larger investment opportunities, but these concentrations made regional direct finance institutions more exposed to external shocks. Institutions have relied on quasi-equity instruments to manage the risk–reward profile of investments. For example, the EBRD uses an instrument known as 'portage', which adds put options to equity investments. Other institutions have provided subordinated loans or, in the case of the Inter-American Investment Corporation, it has included preferred rights clauses over dividends in shareholder agreements, which it can exercise in the event of a delay in buy-out to motivate shareholders to repurchase its shares.

A3.3.2. Development impact

Most DFIs keep track of development effects at the project level. They often track project outcomes in terms of investees' financial performance, economic returns to society (e.g. provision of basic services or investees' contribution to job creation), and environmental, social and governance performance.

FIGURE A3. SECTORAL DISTRIBUTION OF DFI PORTFOLIOS



Source: IADB (2017)

8 As of December 2015, the Asset Management Company had US$8.4 billion in committed investments across 13 funds. Its funds are invested only in IFC transactions, which are selected by Asset Management Company fund managers among all IFC transactions.

They usually attempt to assess the additionality of their interventions in terms of private sector development. At the same time, direct finance institutions often do not analyse development results separately for individual financial instruments such as equity, with the exception of equity investments through funds, which most categorise as a specialised 'sector'. Confidentiality issues particular to equity investments, such as the potential for disclosure of non-public material information, further compound the difficulty of assessing specific project results.

Several independent evaluations prepared by direct finance institutions show that they played an important role in creating equity investment markets, but this impact decreased as the industry matured. For example, an independent evaluation of the IFC's activities supporting equity investment funds found that during the 2000s, the IFC accelerated its participation in equity investment funds, but that as markets matured, its role as a fund provider diminished.[9] The IFC's development impact success rates from equity investments were similar to loans, but financial success rates were lower.

A3.3.3. Financial performance

Returns from equity portfolios have been highly sensitive to macroeconomic returns. Direct finance institutions such as the EBRD and the Netherlands Development Finance Company achieved double-digit returns before the global financial crisis, but returns fell during the crisis and have not fully recovered. Even global institutions such as the IFC have seen returns fall due to low commodity prices and depreciation of local currencies, highlighting the importance of geographic diversification. Diversification of instruments (debt and equity) did not reduce the overall volatility of returns. By comparison, the combination of funds versus direct investments has a significant impact on performance. For example, the Netherlands Development Finance Company strategy of predominantly investing in funds provided lower average returns, but helped to stabilise performance during the crisis.

To compare returns between direct investments and PEFs, overhead costs and management fees need to be considered. When investing through funds, direct finance institutions must pay a base commission to the fund manager for administering funds (usually around 1.5-2 per cent of the fund size) and another fee (a 'carry') for returns above a minimum return (a hurdle rate, usually around 8 per cent). In addition, there are in-house administrative costs associated with the origination and supervision of the funds. When investing directly, direct finance institutions receive returns without paying fund management commissions. However, direct investments typically have higher processing costs (e.g. sourcing, structuring, monitoring, divesting) because these processes are conducted in house. Therefore, the correct comparison between instruments should include management fees of fund investments versus the administrative overheads of managing investments in house. Direct finance institutions do not have the cost-accounting systems needed for this type of comparison, but expert opinions are available.

Direct finance institutional reports indicated that gross returns and volatility for direct investments have been higher than for PEFs. At the IFC, the median IRR on fund investments was about 1.7 per cent per annum – which is below the median IRR for non-fund investments. Nevertheless, after considering operating costs, estimates indicated that PEF investments ended up with a slightly higher net return than direct investments. Direct investments tended to be more volatile, as they do not have the natural diversification of funds.

Direct finance institutions reported that returns on PEF investments are mostly driven by market conditions rather than value addition provided by fund managers. In the case of the EBRD, the Office of Evaluation and Oversight reported that fund managers could add more operational value to companies in sectors like retail and ICT, rather than more traditional and mature sectors such as financial institutions or manufacturing.

A3.3.4. How DFIs invest in equity

The Office of Evaluation and Oversight identified the following four stages for managing equity: (a) origination; (b) structuring; (c) supervision and value addition; and (d) exiting and lessons learned.

Origination

Only a few direct finance institutions, such as the IFC, used a top-down approach to identify investment opportunities based on country and sector gap analyses. Most rely on a bottom-up approach to identify individual investment opportunities as they arise. The assessment of potential investment opportunities is a high-churn process, with only 2-5 per cent of initial

9 World Bank (2015, p.40). ADB's Operations Evaluation Department reported similar findings in its evaluation (ADB, 2008).

candidates being cleared for potential investment. When sourcing investment opportunities, institutions need to consider potential conflicts of interest with loan investments. Most deal with these conflicts by establishing 'Chinese walls' (barriers to the flow of information) between the teams structuring debt and those dealing with equity.

Some institutions avoided entering debt-holder and shareholder positions at the same time, while others actively sought to place equity with existing debt clients where they had a strong relationship. Conflicts tended to be more acute when: (a) listed equity is involved (because of potential non-public, material information); and (b) the client enters a distress situation (because of opposing interests on the company's assets between debt- and equity-holders), particularly when investments for third parties are involved (though a syndicated dual tranche A/B loan).

When investing through funds, direct finance institutions focus on selecting the right fund manager instead of specific investments. All those interviewed agreed that the quality of the fund manager, as evidenced by the track record, was fundamental to achieving strong financial performance. Working with experienced fund managers usually reduced risks and improved return prospects. The EBRD estimated that, over the period 1992-2013, the returns from a first-time fund manager were 11.2 per cent, compared with 22 per cent for a follow-on fund. Occasionally, institutions co-invested with PEFs and thus provided significant cost savings, but in many cases they could not respond sufficiently quickly to realise these benefits.

Structuring

Direct finance institutions usually do not seek to control the operation of investee companies, and take an initial shareholding in the range of 5-20 per cent. In part, they do not want to displace private investors, but view their role as catalysts to attract other investors and support companies to improve their business practices. Some institutions will appoint a board director, and many actively vote their shares. They need to reconcile the need to have a share that is sufficient to influence companies' governance, strategy and business practices, while managing investment risks.

Direct finance institutions indicated that they enter a direct equity investment with the expectation of an investment horizon of between three and 10 years. Exit options are usually anticipated and carefully scrutinised at the time of approval. However, exit is usually a process, and market conditions often lead to delays. To address investees' funding needs and manage risk, some invest through quasi-equity or mezzanine debt. These instruments can be complex to structure, and are less attractive to investees in low interest rate environments. Negotiations with fund managers are much more standardised than direct equity, and risk is usually managed through diversification rather than the use of alternative instruments.

Supervision and value addition

Direct finance institutions usually detail value-adding approaches and some incorporate them as part of their closing agreements with investees. For example, the EBRD documents its approach in value-adding plans that are made part of closing documents with every investee. The EBRD usually cannot require these plans to be executed exactly, but rather on a best-efforts basis, because the business situation evolves and the imposition of detailed plans could be equated to 'managing' the business. Nevertheless, these plans serve as the basis for arranging the ongoing follow-up of investments.

The monitoring and risk management of equity investment requires specialised capabilities. The economic value of debt investments is usually predetermined, and value deterioration is narrowly managed in the event of (potential) default. Equity investment does not provide this level of certainty, as its value is potentially highly volatile and difficult to establish in the absence of recent, deep market transactions in the same type of equity instrument. Portfolio management units and risk management staff are required to manage value addition and exit. Proper valuations are essential from a fiduciary perspective, as they can affect the financial statements of the institution and be subject to external audit.

Direct finance institutions are required to ensure that minimum environmental, social and governance standards are observed in all their investments. This is difficult for equity investments, as they do not control the investees. Unlike debt investments, direct finance institutions cannot impose strict covenants requiring adherence to such standards. Several negotiate 'policy' puts with the investees' controlling shareholders that allow them to exit the investment in the event of material non-compliance with environmental, social and governance issues. While these puts are rarely exercised, they can strengthen the institution's position when trying to enhance environmental, social and governance performance. Equity also allows them to influence management as a shareholder (by exercising their vote) and as a board member.

Dedicated value-creation teams have been introduced by the EBRD. These teams are staffed with specialists, who are responsible for leveraging the resources of the organisation and its partners to add value to investees, according to a predefined value creation plan that specifies focus areas, activities, responsibilities and deadlines. The EBRD plans to dedicate three to four full-time-equivalent staff (about 10 per cent of total dedicated equity investment staff) exclusively to value creation, who will work within the 'equity network' that is made up of 'equity execution leaders' and 'sector bankers'.

By comparison, investing in PEFs takes a more 'hands-off' approach than direct investing, and the supervision role focuses on general oversight of the fund managers' performance to ensure that they stay within the fund mandate and established limits. Direct finance institutions usually participate in the advisory committee with a view to collecting information about potential co-investment opportunities. Fund managers are provided with support to extend their networks with other financiers and investment opportunities. Institutions rarely participate in the investment committee, which makes the actual investment decisions.

Exiting and lessons learned

Direct finance institutions exit direct equity investments through three main mechanisms: (a) a strategic sale; (b) an IPO; and (c) buy-back. A strategic sale to an external private investor is the primary method of divestment. IPOs are less common, as capital markets are not well developed in most countries of operations. The third method is to sell shares back to existing shareholders at a predetermined price, which is also relatively uncommon. Shareholder agreements often provide special rights to protect minority shareholders and make their exits easier. These rights can be in the form of 'tag-along' or 'drag-along' rights, and put or call options. These exit mechanisms are critical as, unlike loans, which generate periodic income, equity generates most of its returns when it is sold at a multiple of the original investment.

Many direct finance institutions indicated that they had difficulties establishing effective governance arrangements to manage divestments of direct equity and ensure that they occur within a reasonable time frame. The best practice is to establish predefined investment milestones after origination, to avoid subjectivity (e.g. 'falling in love' with the investment) and overly risky behaviour (e.g. attempting to speculate in the market).

By comparison with direct investments, exits from PEFs are straightforward. Funds are usually structured so that they self-liquidate at the end of the investment cycle. At the moment of inception, fund managers 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.

A3.4 The World Bank's evaluation of IFC support to capital markets

The World Bank's evaluation of capital markets (World Bank, 2015) indicated that the World Bank Group extended limited support to the development of public equities markets over the evaluation period, partly due to diminished level of equitisation. Equitisation prospects had receded as the costs of the traditional model of becoming a public, listed company were too high for most small businesses; this meant that the IFC's support to intermediaries and infrastructure for public stock markets also declined. By comparison, the IFC's role in private equity accelerated in the 2000s, following the establishment of a dedicated funds management department.

The IFC has a large portfolio of investment in emerging market PEFs, and it is the largest emerging market fund of funds. Despite the size of this investment, the IFC's role was small as a proportion of global investment volume. During 2004-14, it represented 1 per cent of total capital raised globally (8-10 per cent of the funds in which it participated) for investments in emerging market PEFs. Offsetting this result, IFC's average share in these funds was around 12 per cent, and the total value of these funds, in which the IFC was a significant minority investor, was 8.5 times higher.

The IFC played a counter-cyclical and frontier market role. Its share of global commitments increased to 2 per cent during 2009-10 in the wake of the global financial crisis, later dropping back to 1 per cent. The financial performance of its private equity investments has been mixed, with 44 per cent of the funds originated during 2004-09 having negative returns. This poor performance has limited the IFC's ability to attract new investment.

As the private equity industry has matured in client countries, the IFC's role as a fund provider has diminished, although it continues to play a catalytic role supporting first-time fund managers and, especially, in setting high environmental, social and governance standards. By comparison, its direct impact on the development of public securities markets is negligible, and most of the time, it was not an objective. IPO exits are not a feasible strategy in most client countries and consequently they are rare. Private equity development can, at best, have an indirect and long-term impact on capital market development.