Achieving equity investment objectives: A review of initiatives since 2007

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EBRD EVALUATION DEPARTMENT
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<th>Description</th>
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<tr>
<td>EvD</td>
<td>EBRD Evaluation department</td>
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<tr>
<td>GAAP</td>
<td>Generally Accepted Accounting Principles</td>
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<td>IFRS</td>
<td>International Financial Reporting Standards</td>
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Defined terms

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<tr>
<th>Term</th>
<th>Description</th>
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<tr>
<td>Additionality</td>
<td>The Bank complements rather than displaces private sector finance. It does not finance projects that can be funded on equivalent terms by the private sector.</td>
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<td>Board document</td>
<td>Operation report of the EBRD</td>
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<td>EBRD or “the Bank”</td>
<td>The European Bank for Reconstruction and Development</td>
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<tr>
<td>Transition</td>
<td>As stated in the Basic Documents of the EBRD Article 1 “In contributing to economic progress and reconstruction, the purpose of the Bank shall be to foster the transition towards open market-oriented economies and to promote private and entrepreneurial initiative in the Central and Eastern European countries committed to and applying the principles of multiparty democracy, pluralism and market economics.”</td>
</tr>
<tr>
<td>Transition impact</td>
<td>The likely effects of a project on a client, sector or economy, which contribute to their transformation from central planning to well-functioning market-based structures</td>
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<td>Transition impact monitoring system</td>
<td>Transition objectives are translated into benchmarks to be monitored during project implementation (TIMS). The score assigned to a project is based on a combination of the Transition Impact Potential and the Transition Impact Risk of the project.</td>
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Executive summary

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

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

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

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

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

The articulation of corporate governance as an equity-specific transition objective has become more evident since the 2009 EvD study. However, approaches in practice have not developed in line with the greater prominence. There is no structured and coherent approach to securing corporate governance gains through equity investment. Sample review indicates an insufficient understanding of governance and the influences on its effectiveness: analysis of governance factors is sparse and the formal setting of specific objectives for nominee directors is not common practice.
Transition benchmarks overwhelmingly focus on ‘measurable’ governance indicators such as appointment of a Nominated Director. They only rarely address the numerous other factors which influence governance effectiveness. Monitoring reports barely capture meaningful aspects of good governance.

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

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

Conclusions and issues for further consideration

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

- A strengthened equity portfolio review process, supported by more useful data and interaction over exit readiness from a transition perspective;
- Substantial progress on portfolio and investment financial performance monitoring (related to the Equity Portfolio Monitoring Unit);
- Improved financial and strategic analysis and commentary in investment approval documents;
- Enhancements in risk analysis and the setting of equity related measurable benchmarks (from the Transition Impact Monitoring System).

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

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

- The equity approach lacks a clear emphasis on value creation from pre investment to exit and is undermined by the monitoring report structure;
- Monitoring reports and the existing project monitoring system are no longer fit for the purpose of equity monitoring. Arguably a redesigned approach is required for equity monitoring;
- The investment process does not define expected equity results ex ante in an integrated way across the EBRD (linking the related dimensions of returns, risk, and transition);
– Corporate governance underpins the equity rationale for EBRD equity investment but is not being adequately incorporated into the EBRD’s equity approach. There are also questions around the effectiveness of engagements with nominee directors.

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

The study makes the following three recommendations:

**Review the equity approach**

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

**Review the equity monitoring report**

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

**Modernise Board documents for equity content**

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

1.1 Background and objectives

This equity study assesses the extent to which initiatives taken in equity investment and management by the EBRD since 2007 are contributing to better achievement of the Bank’s equity investment objectives. This study follows the 2009 Equity Exits evaluation report (the ‘2009 Study’) that highlighted a number of areas where the EBRD’s equity practice could be strengthened.

Management broadly concurred with findings of the 2009 Exits study but highlighted some (then) recent initiatives that were not reflected in the 2009 report. This study therefore considers how far the aspects of equity management previously identified as needing strengthening have been addressed. It also identifies where further opportunities for strengthening practice may be possible. A secondary objective of this study is to identify the extent to which the EBRD is defining equity operation objectives in a way that are specific, measurable and amenable to post-investment monitoring.

1.2 Study approach

This study has been structured around the three elements which together make up the ‘equity story’ as implemented at the EBRD – value creation, transition impact and risk (Figure 1):

Figure 1: The equity story

<table>
<thead>
<tr>
<th>Value creation (Section 2.1)</th>
<th>Transition impact (Section 2.2)</th>
<th>Risk (Section 2.3)</th>
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<tbody>
<tr>
<td>Generating value growth through a combination of:</td>
<td>Securing transition impact, with an emphasis on introducing and embedding superior standards of:</td>
<td>Achieving financial returns that compensate the risks through value creation and managing the Bank’s risk exposure at acceptable levels through:</td>
</tr>
<tr>
<td>- new markets/products</td>
<td>- corporate governance</td>
<td>- effective risk assessment</td>
</tr>
<tr>
<td>- operational efficiencies</td>
<td>- transparency</td>
<td>- factoring risk into investment and pricing decisions</td>
</tr>
<tr>
<td>- capacity/production increase</td>
<td>- business conduct and compliance</td>
<td>- implementing actions to minimise identified risks</td>
</tr>
<tr>
<td>- consolidation (geographical)</td>
<td>...underpinned by additivity, where the EBRD is securing transition which could not be achieved by other equity investors or where alternative equity sources are not available on market terms.</td>
<td>- factoring risk into exit considerations</td>
</tr>
<tr>
<td>- restructuring</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- improvement in management</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- availability/use of leverage</td>
<td></td>
<td></td>
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<tr>
<td>- potential for expansion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>…with good management at the core of securing these drivers</td>
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These three elements need to come together to support sound equity investment and require:

- structured assessment pre-entry;
- clear monitoring and re-assessment during the life of the investment;
- specific and measurable objectives to support post investment management and recognition of results.

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1 The Bank’s equity objectives and approach are outlined in a number of documents, most importantly the Agreement Establishing the Bank, the Operations Manual & Guidelines and the document “EBRD Equity – Policies, Processes and Strategic Issues (June 2009)”
The EBRD approach to equity places standards of business conduct and corporate governance at the heart of transition impact potential for equity projects. This is the only source of transition that features consistently across all equity investments under this study, unlike other sources of transition which are not usually uniquely equity-related. This study therefore gives prominence to governance in the section on transition impact but it should be noted that engagement on standards of corporate governance is fundamental to effectiveness of equity investment and is equally important to value creation and risk assessment.

This report is based on the findings of a structured desk review of core documents for 17 equity investments made between 2007 and 30 June 2011 (the sample), together with interview input from some of the key personnel involved in equity management. Annex 1 presents analysis of the study population, sample selection and approach to the sample review. Annex 2 presents an example of the equity review template used to summarise findings for each of the sample investments. Annex 3 presents summary analysis of findings drawn from the sample review and on which findings in this document are based.

1.3 Equity management context within the EBRD

This report should be seen in the context of an on-going initiative by EBRD Management to strengthen the portfolio management function, including specific equity actions. Much of the current direction of development in the way equity is managed flows from the findings of the 2009 working group set up under an operational capacity building exercise. 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. Working group recommendations included redefining and resourcing the position of Managing Director (Portfolio Business Group) with a major focus on post investment equity management to ensure Banking Department follow-up on equity issues. The working group also identified other important issues, for which further analysis and consideration was required to generate proposals for solutions. Some of the issues identified by the working group are reflected in this report, in particular the need for a reorientation of equity management processes and tools to support a value creation objective.

1.4 Structure of the report

Section 2 has been structured in line with the three elements of the EBRD equity story:

- 2.1 Value creation
- 2.2 Transition impact
- 2.3 Risk assessment

Under each of the three themes, a selection of statements on ‘good practice’ is presented. Under each statement of good practice, three standard sections follow:

- a synopsis of findings from the 2009 study and the management response;
- findings from this study; and,
- suggestions for further strengthening of EBRD practice.

Each of the sections has been distinguished with the following formatting:

| Good practice: an outline statement on an aspect of good practice relevant to the sample |
The overall analysis and conclusions of this study must be viewed within the limitations of the sample and methodology. The study concentrates on core documents and key issues that emerge. It cannot capture in its entirety the full expertise and multiple processes brought to bear over time on complex investments. Therefore it should be seen as the basis for discussion of potential enhancements to practice and process, rather than as a representative or definitive analysis on aggregate achievement of equity results. However, even applying this modest standard yields a good number of practical suggestions, identification of opportunities for improvement and a small number of important recommendations.

There are two specific circumstances relating to the EBRD’s equity investments that the reader should be aware of when considering the findings and suggestions of this study:

i) At year end 2012 EBRD equity category two projects with global sponsors represented 17 per cent of the equity portfolio at current cost. In category two investments the EBRD usually has a defined exit (usually through a put mechanism) with limited downside risks and limited upside potential for gain. Value creation and implementation of good corporate governance practice rests with the sponsor and company management. In broad terms, category two investments represent a declining share of the EBRD portfolio, whereas category four and five investments (regional and local sponsors respectively) represent a rising share of the portfolio. It may be argued that the EBRD would want to apply a differentiated equity approach to various categories of sponsor or according to the size of shareholding and strength of shareholders’ agreement. This study has not calibrated findings according to sponsor type, ownership characteristics, or share of equity held.

ii) The operational capacity building working group report mentions the variable equity experience, expertise and practice found within the EBRD, where two business groups were identified as needing additional support and the Financial Institutions (FI) business group was identified for its relative expertise in equity management. This study concurs with the experience of variable practice and also received consistent feedback that equity practice is stronger in Financial Institutions, although this came across less clearly in the standard bank-wide document sets reviewed under the study. Some stakeholders may feel that study findings have less applicability to their teams but the point is made that where examples of good practice exist they should be formalised and adopted across the EBRD. The study takes an ‘overarching’ view of equity practice within the EBRD and has not specified findings according to their applicability to different business groups.
2. Study findings

2.1 Value creation

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<td>A clear articulation of how value is expected to be created, including:</td>
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<tr>
<td>- Consideration of interdependencies between drivers of equity value creation</td>
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<tr>
<td>- Factoring in the potential risks to achievement, management of the risks and mitigation</td>
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2009 findings

It was agreed that scope existed to improve presentation of value creation opportunities and objectives, and to reinforce progress being made in the valuation review process.

There are clear improvements in the EBRD’s equity approach. A more structured monitoring of financial value on both an individual and portfolio basis is evident compared to the 2009 position. Further information on this, including functioning of the Equity Committee, role of Equity Portfolio Monitoring Unit, recent introduction of value creation plans and enhanced equity reporting to the Board, can be found in Annex 4.

However, improvements to strategic management and reporting of equity have not been matched by developments in the approach to individual investments. Still missing for the sample investments was a consistent and well-structured narrative setting out the equity story. Fewer than a third (five) of the 17 set out a well-defined value creation statement with a description of the value drivers and a third had made an attempt but lacked clarity. In some cases there was unstructured content indicating that thought had been applied to the equity story but the drivers of value and interdependencies and their respective risks were not explicit or clear.

Gaps in the definition of value creation were seen to hamper effective monitoring during the life of the investment. There was little evidence that appropriate material was being presented in the value creation sections of monitoring reports - in some cases the wording is unchanged from that adopted on entry, even two years after investment. Only one investment from the sample (Client RG) was identified where monitoring reporting effectively tied into value creation objectives. In six others it could be vaguely discerned and in the rest it was absent.

2.1.1 Monitoring examples:

- Client MW: discussion of progress on value creation is limited, even after delays in the project kick-in and start undermining value creation
- Client SC: Value creation analysis and objective setting is limited from the outset - overly brief and no emphasis on the drivers of value creation. Gaps in definition at the outset prevents effective monitoring of progress or success around key drivers

As demonstrated by a series of recent initiatives and confirmed during interviews, Management has recognised the need to improve the equity narrative and are in the process of strengthening the project level approach. New formats to be used in project preparation and monitoring include updated equity term sheets, company value creation plans and the Value Creation Key Steps Annex. These formats encourage clearer definition of value creation opportunities, actions and objectives at all stages and bring much more focus to the equity narrative. The equity project descriptions prepared for some time by the Financial Institutions team are already an effective tool. Those involved in equity management in the EBRD have commented that the Financial Institutions business group generally has better developed...
approaches and tools for managing equity, including a departmental value creation process that runs on a quarterly review cycle. This may be another example of approaches being developed at a business group level to supplement process, such as monitoring that exist across the organisation but are not fully serving the needs of teams.

A thorough review of the monitoring report structure generated by the automated project monitoring system is in process under the Managing Director of the Portfolio Business Group. It is evident that the monitoring report format generated by the system is not appropriate for equity. It is largely based on a format which is twenty years old and originally designed to support loan projects. The format has only evolved to the extent that additions have been made to meet the specific needs of individual units. The result is a report which is ‘box driven’ and lacks coherence and the necessary structure for equity monitoring and management. The quality of much of the completion of monitoring reports points to issues of oversight and accountability, and very likely reinforces scepticism about the importance and utility of the monitoring reports.

Issues concerning the equity narrative, value creation and monitoring are similar to those presented in the 2009 evaluation study. Material enhancements to the approach are now in the process of being rolled out and will address many of the issues but there is still a requirement for a much higher degree of integration between approval, post investment value creation and monitoring. Value creation, the interdependencies and integration with risk and transition impact, needs to come to the fore of the approach from approval to exit. Drivers of value creation (particularly those relating to competitiveness and corporate governance) overlap with transition objectives. Strengthening the way value creation and transition objectives are specified at entry would lead to more effective benchmarking and development of monitoring indicators. The two processes of equity management / monitoring and transition monitoring, need to be far more integrated, ideally drawing on a single results and indicators matrix.

Measures for improvement
- continued development of the equity approach setting out how the investee company will move from its current position to the targeted profile;
- apply a structured approach to detailing interdependencies and identifying material issues or risks to value creation;
- extend the value creation structure into the updated monitoring report template and completion guidance;
- consider engaging external consultants or peer review in development of the new monitoring instrument. Allowance could be made for review at the development stage and again after a pilot implementation phase for fine tuning;
- increase the integration between equity management and transition monitoring through a shared results framework in overlapping areas;
- re-design the monitoring process to increase the visibility and accountability of line management during the life of the equity investment;
- identify approaches and practices that have been tailored by teams (for example the Financial Institutions group) and consider mainstreaming successful approaches in the equity management process.

Continue development of equity reporting to the Board to emphasise results achieved, challenges and opportunities for the achievement of future results.
Presentation of financial and strategic analysis has improved markedly since the 2009 report. It is consistently more comprehensive and complete. The strategic analysis is put in an overall market context including consideration of macroeconomic, country and sector developments. Financial analysis is detailed and in most cases scenario analysis is used. Two-thirds of the sample (11) are assessed as sound.

The improved analysis has resulted in better challenge during the entry process from the Office of the Chief Economist (at the Operations Committee hearings of new projects) and the Directors’ Advisers (through questions at the Board level). Questions from these sources are well-grounded, perceptive and relevant. It can be assumed that, in part, this has been enabled by the quality of the operation team’s analysis. Stronger presentation at entry is backed up by improved financial analysis during monitoring. Seven of the sample were considered as presenting good monitoring analysis and a further seven as reasonably good.

Presentation would benefit from streamlining. Long paragraphs including data contain the required substance but they can also obscure the picture for readers with a lower appetite for detail but needing clarity about the value creation story and linkages and the wider strategy. Presentation and analysis could be improved in several ways:

- The analysis in Board and monitoring documents is not explicitly linked to the value drivers. These could be set out as headings or side-boxes with a bullet-pointed summary analysis alongside. The lack of readily-visible linkage makes the monitoring assessment or outcome measurement more difficult.

- Complex charts and tables would benefit from short summaries providing the relevant comment on trends or indications in the data - the reader should not have to work at extracting the messages.

- Link risk analysis explicitly to drivers of value creation and sources of transition impact, answering the question: how achievable is the value driver given the risks?

These limitations in analysis and presentation on entry hamper effective tracking during the life of the investment. Monitoring of the financial and strategic development of the business is usually full and it is evident that in most cases effort is put into providing a useful picture. However, monitoring is undermined by the lack of clear tie in to the sources of value creation and risk identified at entry.

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**Value creation good practice 2**

Well-structured and relevant financial and strategic analysis on entry including:

- Tie-in to the relevant value drivers to allow ready assessment of the potential sources of value creation;
- A linkage between value drivers and risk analysis to help determine the extent of the risks and their potential financial or operational impact.

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**2009 findings**

Scope existed for better structured financial and strategic analysis to underpin the case and to set out the opportunities for value creation. Management agreed that it was timely to develop the form and process of management review of value creation.
2.1.2 Clarity of analysis examples

- Client L: good scenario analysis with helpful narrative relating to scenarios including good definition of assumptions, including consideration of a “worst case” scenario;
- Client T: analysis at entry was presented in a sound way, but subsequent events raise the question as to whether sound banking principles were applied in the analysis;
- Client VG: financial reporting is full but the impact is lost through the absence of clear key performance indicators.

Measures for improvement

- Use the impending review of the structure of the final review memorandum and Board document as an opportunity to introduce specific equity elements, particularly providing more explicit linkage between the financial investment, value drivers, risks and expected results.
- Set out a clear and measurable results framework and key performance indicators in all cases.
- Breakdown the analysis in the final review memorandum, Board documents and monitoring into more accessible, better signposted narrative.
- Review the need for such a structured ‘box-driven’ monitoring report.

Value creation good practice 3
An objective and probing assessment of management including:

- considering management capability in the context of challenges and risks and going beyond simple listing of short biographies;
- assessing the appropriateness of the management structures;
- monitoring the impact of management developments on likely achievement of objectives.

2009 findings
The assessment of investee company management was considered to be weak, with scope existing for better analysis even within the constraints of being an outside investor. Management agreed that scope existed for improved documentation.

There has been a slight improvement in that a reference to the quality of management is included on a consistent basis. The efficacy of the reference mostly varies between minimalist and partial.

The Bank’s approach to value creation correctly highlights management capability as a crucial factor. This is not, however, reflected in the documented assessment of management seen in Board documents:

- in most cases it is limited to the provision of curricula vitae. In a few others it is accompanied by a limited reference to prior knowledge of management from past or existing relationships;
- there is no structured attempt to assess management capability versus the challenges or risks facing the business or the requirements of successful value creation;
- the depth of the management team or the existence of credible succession and contingency plans is rarely considered;
- Management structures are not assessed (for example the number of reporting lines into the Chief Executive Officer or the depth of the management team).
In only three cases was management quality assessed in the final review memorandum (final project proposal approved by the EBRD Operations Committee) and Board documentation to any degree; in all other cases it was absent or inadequate (limited to simple presentation of brief curricula vitae or thumbnail profiles). Certainly in many cases key management may be known to the EBRD, for example from previous transactions or market knowledge, but this does not obviate the need for a proper assessment of management versus the requirements of a value creation plan. This was also a significant omission identified in the 2009 study.

It is recognised that there may be a limit to the extent that the EBRD can make an effective management assessment as an outsider but the process should at least identify future challenges to be discussed with management, and assessed as a risk to value creation. This in turn would help identify possible mitigants to reduce risk and which can be followed through by the nominee director and tracked as a risk exposure.

During the life of the investment, the monitoring reports contain only limited or no reference to management developments despite the recognition that management quality and delivery is a crucial factor. In several cases there were significant changes in management but these received only a passing reference with no discussion of the possible implications for the achievement of objectives or governance.

2.1.3 Management assessment examples

- Client PI: a lack of experience of expansion into European markets on the part of the Icelandic sponsor was a risk which should have been assessed more effectively and monitored as a key driver of success;
- Client CP: lacked analysis of management capacity. Management ability and integrity subsequently came into question (for example in relation to possible irregular payments by the Chief Executive Officer). As significant issues arose, these were noted in passing in the monitoring report but no explanation was given of these crucial developments;
- Client EC: an inadequate assessment failed to identify a lack of basic financial management skills;
- Client GP: an over-reliance on experience from the relationship with the parent obscured significant needs for management strengthening and governance issues;
- Client SC: a very limited focus on key-man risks was highlighted by the departure of the Chief Technology Officer.

Measures for improvement

- Adopt a more structured and rigorous approach to assessing senior management capability and resource against requirements of the value creation plan, value drivers, risks (including key man and succession risks) and critical success factors. Integrate enhanced assessment in Board and monitoring documents.
- Identify possible requirements for changes in management structures and practices which can be highlighted to management and the nominee and tracked in the monitoring process.
- Make management issues a standard consideration in the monitoring, including changes in key management positions. Where management changes take place, include an assessment of the potential impact.
Across the sample, the basis for the pricing decision was set out clearly in the final review memorandum approved by the Operations Committee, a distinct improvement relative to past practice. In nearly all sample cases the basis was also explained clearly (although in three of the samples it was overly brief or nearly non-existent as a description). Alternative valuation bases were set out in two-thirds of cases; the remainder presented no reference to alternative valuation approaches or only vague references.

Notwithstanding the improvement, there is further scope for a tightening of the assessment – or at least its presentation:

- In some cases the Credit department raised issues as to the appropriateness of the price being made but the response remains unclear from the Operations Committee minutes or the final review memorandum. Examples include:
  - Client L: Credit department concerns about pricing and valuation are not addressed in the documentation and give the impression of being dismissed;
  - Client T2: Credit concerns over pricing do not appear to generate a response.
- It is not evident that exit horizons are factored into pricing. Some scenario analysis is included but this relates to indicators of performance and the impact the internal rate of return; it is not used to establish a price range which depends on the possible range of exit timing. Only three of the samples factored in alternative exit timings: Client AG, Client EC and Client T2.
- Better explanation and higher prominence should be given to exit timing in the approval and monitoring reports as it is a key factor influencing financial return. Whilst there is a target exit date, there is little discussion in the documentation as to the likely success in achieving this and in none of the sample cases was a range provided. Experience from the 2009 evaluation study and Management’s follow up revealed a distinct underestimation on the average life of investment. Exit timing receives little attention in monitoring reports but is now included in the Equity Portfolio Monitoring Unit’s data collection fed into Equity Committee and the equity value creation review process. This partially compensates for the lack of focus on exit timing in monitoring reports.
- The factors in the discount rate used in valuation are not stated explicitly in the final review memorandum. If it is the case that the risks identified in valuation analysis are factored in, it is unclear. The extent to which is has happened should be explained with reference to specific risk levels (that is post-mitigation) and how they have influenced the entry valuation and internal rate of return.

**Value creation good practice 4**

A solid basis for pricing and estimation of returns is used and set out in approval documents, including:

- clear explanation of the basis for the pricing decision;
- a linkage of return estimates to risk;
- factoring of exit horizons into pricing.

**2009 findings**

The basis for valuation was frequently unclear with the methodology not being consistently set out. Consequently the linkage to pricing and the validity of the internal rate of return forecast could not be assessed by the study.
Definition of the possible exit approach has improved markedly. In particular, detailed consideration was given in the sample to the exit opportunities should an initial public offering or trade sale fail to materialise (for example through use of put or call options). Alternatives were fully assessed and well explained. In 11 cases definition of the exit case was found by the study as ‘good’ with all others being acceptable.

In some cases the assessment of the likelihood of an initial public offering or trade sale could have been more rigorous and on some occasions the Credit department questions how realistic the exit options are but it is unclear from documents how far these concerns were addressed.

2.1.4 Credit issues examples:

- Client O: The Credit department questioned the validity of the exit strategy as well as the strength of the investment case, expressing doubts around business strategy, financial performance and the organisation’s capacity and capability to deliver (the issue is the clarity of the documented process not the investment return, which was an internal rate of return of 62 per cent following exit in two years).
- Client PI: The Credit department questioned the quality of the put based on the strength of the counterparty.

Post investment practice is variable. In some cases the monitoring report was updated for the viability of the envisaged exit route in and some cases other options are reviewed. In others, however, there is little reference to how changing circumstances or performance may undermine the proposed exit route even in some cases where the risk profile had clearly deteriorated. Of 14 cases in the sample (where on-going exit analysis was relevant), ten presented ‘satisfactory’ (but not ‘good’) observations on developments, the remaining four did not update exit development effectively.

As described above the process for reviewing exit suitability has now been strengthened through review by the Equity Committee. The outstanding question may, therefore, be more related to how this assessment is documented as part of the monitoring and control process. The current monitoring report
format does not capture development in the exit outlook, so consideration should be given to how Equity Committee deliberations are captured and fed into the equity management and on-going monitoring process.

**Measures for improvement**

- In all cases where an initial public offering or trade sale is identified as the preferred exit route, include an ex ante discussion of the likelihood of this being achieved during the target timeframe. Highlight the risks to the preferred route being open and assess the significance and probability of these risks crystallising. Consider introducing a 'likelihood' scale as an indicator.
- As part of the process of reassessing the exit options, consider how this is captured in the reporting process, possibly including an 'up/down likelihood' indicator or 'traffic light' assessment and specific inclusion of new exit opportunities that may be emerging.
- Introduce a more systematic recording and tracking of responses to issues raised by Credit and other support units at Operations Committee.

### 2.2 Transition impact

**Transition impact good practice 1**

A structured approach to equity investment that captures incremental transition impact potential and results including:

- Transition impact assessment at entry integrates transition potential and the drivers of equity value creation;
- transition benchmarks are specific, measurable and amenable to post-investment monitoring and evaluation;
- a data-based monitoring focus on actual transition performance relative to stated objectives and significant developments that affect benchmark indicators;
- consistency during the life of the investment between the transition impact assessment at approval and during monitoring, adjusted for mid investment developments.

**2009 findings**

The need for better articulation of fulfilment of mandate objectives through using equity was highlighted, in part to justify more strongly the use of equity. Management recognised this to a degree, with a response focussed on the importance of governance objectives. Changes to the final review memorandum, monitoring report formats and exit information notes were suggested by the 2009 evaluation study to allow focus on progress of the investment and developments relevant to value creation, the exit strategy and transition impact objectives. Management felt this could best be achieved through the transition impact monitoring system plus additional analysis of transition impact assessment at the point of exit and communicated through the Exit Information Note. It was commented by Management that the monitoring report format was revised extensively in 2007 and the Equity Portfolio Monitoring Unit has improved reporting on exits to the Equity Committee.

Greater emphasis on transition impact at entry is evident in the sample. Five investments gave a clear emphasis and almost all others showed positive signs of greater emphasis on it. The definition of transition impact objectives has improved to the extent that benchmarks are specified and tied into objectives. These are effective in providing a degree of focus and a structure for reporting.

Two-thirds of the sample (12 investments) emphasised ‘competition’ and ‘demonstration effects’ as the relevant transition indicators. The relationship between transition indicators and the overlap with drivers of value creation for the equity investment is unclear. Where the transition indicator (for example competition) and benchmarks (such as market share, geographic coverage or number of competitors) are
commercially driven, the whole transition impact case could be strengthened by integrating the overlapping value creation and transition dimensions, and risks to achievement). In the majority of cases there was opportunity to strengthen the linkage between objectives (operational and transition) and the benchmarks set for the projects. In some cases attempting to make non-quantifiable goals measurable was seen to reduce the value of the benchmark. This is particularly evident in relation to governance goals. For example, the governance benchmark is usually specified as ‘appointment of a nominee director’ or the adoption of a ‘governance policy’. While these are measurable indicators, the benchmarks in themselves do not generate transition impact – the nominee director may have no influence or be ineffective or the governance policy may be superficial with little practical impact. In an area as complex as governance, meaningful assessment requires structured narrative and a more sophisticated assessment than is permitted through the benchmarks alone. In the governance area, it may be necessary to accept that ‘objectively verifiable’ might not mean ‘measurable’ and that verification may need to be done through a rating or scoring system against a narrative rather than through a benchmark measure. Such an approach would be principles based, rather than prescriptive as often found in legally based codes, and should have the capacity to develop over time as the concept of governance evolves within the enterprise. This study has not considered the resource implications of introducing a principles based approach.

This is complicated by the fact that ex ante analysis of governance issues is not presented in approval documents, so it is unclear what gaps need to be filled or issues addressed and therefore reflected in benchmarks. Analysis of the governance benchmarks used in the sample highlights the wide range of structure, terminology and differences in approach, (Annex 5). Analysis of the sample indicates that there is no consistent and structured analysis of governance related transition impact potential. Pre-disbursement is the time when the EBRD has perhaps the greatest opportunity to engage with a company on what shape its future governance will take, yet findings from the sample indicate this is not happening on an effective or consistent basis. Corporate governance is considered further in the following section 2.2.2, ‘Transition impact good practice 2’.

There were few examples in the sample where the Office of the Chief Economist input to the Operations Committee meeting at the final review memorandum stage was reflected in the subsequent Board document. Comments from the Office of the Chief Economist usually related to improving the definition of transition impact benchmarks. In most cases this resulted in some tweaking or re-ordering of benchmarks but little more. In some cases there was no sign of any change being made.

2.2.1 The Office of the Chief Economist input examples

– Client L: More information on corporate governance development plans was requested but a limited response was given. Governance subsequently became a problem.

– Client MM: The Office of the Chief Economist expressed concerns over the Sponsor but these were not addressed in the Board document (later becoming an issue as a major shareholder looked to sell down).

Transition impact monitoring system reporting on progress towards achieving transition benchmarks was found to be satisfactory, albeit with several qualifications. In some cases performance was not updated between successive reports or, in one case, the overall assessment was contradicted in the monitoring report. In a number of cases, the system’s report indicates ‘achievement’ of governance benchmarks but this is contradicted by references elsewhere in the monitoring or credit reporting to governance problems. Such mismatches highlight the limitations of the benchmark based approach. Where these contradictions arise there should be an informative explanation of the divergence.
In some cases the benchmarks change between the Board document and subsequent monitoring reports and transition impact monitoring system reports (including in cases between subsequent transition impact monitoring system reports) with no commentary on the basis for change. This makes monitoring more difficult and gives a sense of moving objectives. The lack of linkage, or in some cases apparent contradiction, between the transition impact benchmark rating and other information provided in the monitoring report does suggest a need to consider how quality of the assessment is maintained.

2.2.2 Inconsistent monitoring examples

- Client MW: the transition impact monitoring system report on transition impact objectives does not accurately tie into the transition impact benchmarks.
- Client MM: the transition impact monitoring system analysis makes changes to the transition impact objectives and related risks with new risks being introduced (for the better) between one report and the next.

Reliance on transition impact performance rating on transition impact benchmarks alone can generate a misleading picture. Ratings on transition impact performance would benefit from insightful commentary, integrated from the outset with drivers of value creation.

Measures for improvement

- Integrate transition objectives and benchmarks that are competition, market expansion or corporate governance based with value creation drivers. Apply a common assessment ex ante and during monitoring;
- Adopt a descriptive or scoring approach to defining and monitoring transition impact benchmarks that are qualitative in nature;
- Introduce a quality assurance process to ensure transition impact monitoring system reporting is consistent with monitoring and credit reporting. Explain the reasons for divergence;
- Ensure consistent use of benchmarks throughout the life of the investment and across different reports. Provide explanatory narrative on updated performance, tied in to the original assessment and comment in changes to the benchmarks themselves.

Transition impact good practice 2

- Recognition that corporate governance is crucial to definition and achievement of both transition impact objectives and value creation.
- Demonstrate a clear understanding of the concept of corporate governance through ex ante assessment and post investment monitoring, including:
  - a recognition of the multiple aspects of corporate governance and the complexity of its operation;
  - clear articulation of corporate governance-specific transition impact objectives;
  - a distinction being drawn between ‘board governance’ and internal control;
  - an explicit push on transparency.

2009 findings

The need was identified to better articulate strategic objectives for governance change. Management recognised that governance is the most important difference between debt and equity in terms of transition impact potential. It was expressed by Management that the approach to governance had been significantly improved, and was being reflected in transition impact benchmarks and monitored through the Transition Impact Monitoring System.

Greater (but not strong) emphasis on corporate governance standards is evident in the sample. The main link to governance was related to inclusion in most cases of Nominee Director appointments as a transition impact benchmark and occasionally reference to governance policies. Beyond this, a clear
emphasis on governance, from appraisal to monitoring, is not visible from the sample documents reviewed. Fewer than half (eight) of the investments show any sign of emphasis on corporate governance; none show it strongly, and the others show little or no emphasis. In only three cases are governance objectives set out as specific objectives for governance change and standards in the company, rather than as functional steps such as appointing an nominee director.

Good governance was frequently emphasised in approval documents to substantiate transition impact and to some extent additionality, arguments. In practice, the conceptual framework was invariably limited to the board of directors and objectives for change limited to securing the appointment of a nominee director or the introduction of a governance policy. This is a very narrow approach to corporate governance. An outline of the main elements of a governance framework is provided in Box 1. A full review of findings drawn from the sample is presented in Annex 6.

Box 1: Aspects of governance to be considered

There are numerous aspects to corporate governance. Some relate to the board of directors, such as:

- mix of directors on the board, nature of board discussion and decision-making, style of chairmanship, role of independent directors, level of information provided;
- relationship between board and executive as individuals (especially the chief executive officer) or as a management board;
- degree of delegation to board committees and the working of those committees (particularly audit).

Others relate to internal management, such as:

- internal reporting and the quality of management information;
- use of committees and their influence;
- degree of control exercised by the centre over subsidiaries or outlying offices;
- existence of a meaningful internal audit function;
- risk management approach and risk reporting to the board(s);
- level of development of structures and policies e.g around compliance.

Others relate to external interaction, such as:

- accountability and reporting to shareholders and other stakeholders (including dividend policies);
- relationships with government, regulators, stock exchanges.

The following paragraphs summarise the treatment found in the sample of some core aspects of corporate governance:

The role of the (supervisory) board

In nearly all cases assessment of the board is limited to the provision of biographies with no attempt to reconcile profiles against what is needed for effective governance. There is barely any reference to the mix and quality of board membership or the conduct of relations between owners, the chairman and chief executive, all of which directly impact on the quality of the board and governance. There are no references to the quality of information or papers submitted to the board of directors - a key factor in determining whether effective governance can be established. Venture capital investors pay great attention to these aspects.

Governance policies and structures

In only two cases is the implementation of a governance policy specified as a transition impact objective, and then the references are vague. Setting out a governance policy or framework is an important step in getting an organisation to think through what it wants its corporate governance to achieve and what it might look like. The lack of a push for formalised frameworks in investee companies is a missed opportunity. In the two cases where policy was mentioned, one presents a fleeting reference to it being 'in line with the EBRD standard policy' (for which no such reference document was found by this study) and
in the other, a document produced by a law firm was provided although it is unclear how it was used in practice. No subsequent assessment of the implementation of policy and changes in practice was found, although references were found to policy adoption as part of the transition benchmark monitoring.

Other internal aspects of the governance framework

Going beyond boardroom governance, assessment is sparse. A view of internal controls or risk management is virtually absent. None of the sample includes a statement on the existence of internal audit, let alone its size, role or effectiveness (the 2009 evaluation study found development of internal audit received a lot of attention). In only a handful of sample cases (for example Client AG, Client VG) is there reference to the need to strengthen management information systems (crucial to both effective governance and value creation) – the 2009 evaluation study found considerable importance was attached to the development of management information systems. No consideration was found of policy aspects that would give an indication of the governance approach or quality (for example insider dealing policies; related party transaction rules; delegation of authority limits/guidance; the nature of reserved matters, the existence and terms of reference of management committees (such as the credit committee, anti-money laundering committee and investment project management committee).

External transparency

There was little evidence in the sample of a push to require greater transparency from investee companies. In part this might reflect an existing trend towards International Financial Reporting Standards (IFRS) reporting amongst investee companies. How far this is the case is unclear from the final review memoranda: only four clearly stated that the company was already reporting on an IFRS basis before investment; in the others there is no explanation as to the basis of the accounting information (except one where it states reporting only on the basis of local Generally Accepted Accounting Principles (GAAP)). In those companies where it was unclear, there was no emphasis on requiring a shift to IFRS accounting (in contrast with the emphasis seen during the 2009 evaluation study). In certain cases, IFRS accounting was expected at approval but the focus was not maintained when there was a delay in producing IFRS accounts; or it was unclear from files what happened.

There is no consideration in any of the investments of how companies report externally either in a structured format (for example through an Annual Report, corporate social responsibility report or ‘business review’) or through websites (including publication of presentations to analysts or bond holders). Unlisted companies may not feel the need to publish this type of information but where they do, it is a useful indicator of governance attitudes. Where they do not, it is a possible governance objective.

2.2.3 Governance examples

− Client E: a heavy emphasis is placed on the supervisory board and a request is made for the establishment of an audit committee and a remuneration committee but this fails to take into account the political context which will make the operation of these structures difficult. The governance intent is evident at the outset but is then not followed through in monitoring.

− Client G: references to ‘complying with the Code’ are confused and imply a lack of understanding of UK listing rules and governance standards. Appropriate directors’ advisors questions on the board make-up were dismissed. Delays in taking steps to implement governance policies appear to go unchallenged. Corporate governance was used as a strong justification for additionality but was then seemingly demoted as problems arose in appointing a nominee director (relating to a lack of due diligence in assessing governance regulation). Achieving governance goals subsequently received little monitoring coverage.
Client VG: there was a good emphasis on governance at the outset but this was not carried forward to the monitoring reporting.

Client T2: a valiant attempt is made to set out the board and committee membership and structures, but is undermined by confusion between executive committees (which these were) and governance oversight committees of the board; also the highly political make-up of the board was not considered adequately. Gaps and lack of structure in analysis resulted in a failure to identify governance issues which become a problem until a new nominee director was appointed to the board and addressed functioning of the audit committee. A commitment was made to annual IFRS reporting but publication then ceased (although this was subsequently addressed).

Recent initiatives introduced by the EBRD’s Legal Transition Team post-date the sample but go firmly in the right direction. A corporate governance checklist is being built into the EBRD due diligence process. The tool was reviewed by this study team and, overall, provides an excellent basis for improved assessment, gap analysis and establishing the basic principles of governance expected by the EBRD. It is evident that, even with the extension of a well-structured governance due diligence process, more needs to be done to communicate the findings and intended actions within the Board document and to integrate with post investment value creation and transition impact monitoring. As the EBRD approach to governance develops, it will be important to ensure that an ‘inclusive approach’ is followed with the client. Experience suggests that impacts will be greatest where the company has ownership of the governance development plan, rather that it being imposed as an external compliance requirement from the EBRD.

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**Measures for improvement**

- Extend the Legal Transition Team corporate governance pilot and continue development of a model of ‘good governance characteristics’. Apply the model to pre-investment analysis, due diligence and extend as a basis for monitoring.
- Review the structure and routine inclusion of corporate governance due diligence findings in the final review memorandum and Board document. Use due diligence findings as the basis for identifying value creation drivers and transition impact objectives / benchmarks. Integrate objectives and action plans into monitoring.
- Introduce formal training in corporate governance analysis and good practice for operation leaders, banking and credit analysts and nominee directors.
- Define the key objectives and characteristics of an EBRD good governance model and use as the basis for promoting the adoption of a corporate governance policy that investee companies should be encouraged to adopt where there is no acceptable policy in place.
- Report explicitly on governance implementation in monitoring (integrating with pre approval value creation and transition objectives).
- Make it a routine requirement (incorporated in the operations manual) to state the position on IFRS account preparation.

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**Transition Impact good practice 3**

An approach to the role and work of the nominee directors which reflects the importance of the engagement, including:

- consideration of the intended profile of the nominee director;
- an explanation of the objectives to be set (tied in with the value creation and transition impact objectives);
- structured reporting on the progress achieved through the nominee director’s presence;
- introductory training for the challenges of the role and the region.
Several initiatives have been introduced to strengthen the engagement with nominee directors and significant effort and resources have been committed by Corporate Equity Group and the Financial Institutions business group over the years to identify and equip nominee directors for the challenges of the region. Given the importance attached to the role in securing transition impact and value creation, there are distinct opportunities to enhance further the process and practice around nominee directors.

No documented process was found for setting investment-specific objectives for nominee directors. Priorities are not documented in the final review memorandum (where they should be tied-in to findings from corporate governance due diligence). Nor are specific objectives established in the terms of reference for nominee directors, which are comprehensive but generic in their coverage. It may be that briefing is provided by operation leaders (and therefore outside of this study’s scope) but in any event, the key objectives should be documented - for transparency, to permit analysis and challenge and for benchmarking so that reports back and nominee director performance can be assessed against the objectives.

A guidance document now provides a clear description of the required scope of reporting back to the Bank from the nominee director. This includes examples of the types of information and indicators of progress that are required. This document is sound and should generate appropriate reporting. Discussions with portfolio managers and a brief survey of operation leaders (Annex 7) indicates that the quality of reporting is variable, with some nominee directors reporting much more effectively than others, pointing to room for improvement and possibly additional training around corporate governance good practice and EBRD requirements (the current nominee director training is orientated towards integrity and compliance).

Survey findings also indicated:

- nominee director reporting on governance assurance and oversight is limited (financial reporting and internal control such as quality of internal audit effectiveness of the audit committee);
- the quality of management reporting and use of key performance indicators is touched on sporadically with only a few nominee directors reporting on this effectively;
- reporting on the nature of decision-making and debate is relatively consistent and sound.

Where there are gaps in reporting, the survey found operation leaders look to obtain a view of these issues from their direct interaction with the company; but with the importance attached to the impact of the nominee director, it would be highly beneficial to be able to obtain the nominee director’s view of such issues. An opportunity exists to generate a more uniform approach and, in many cases, for a push towards more insightful reporting on key governance issues.

The nominee director activity and performance in EBRD internal monitoring reporting is not captured. This hampers the oversight and accountability that can be exercised through the monitoring and equity committee processes. A limited box in the monitoring report provides a brief indication of appointment and attendance but little else. Few of the ‘feedback from company’ fields are completed in any useful way.

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2 ‘EBRD Board Nominee Report, version November 2012’, provided as part of the Office of the Chief Compliance Officer Guidance for nominee directors.
3 No examples of reports were seen during the Study.
4 13 respondents out of 17.
There is no narrative. In most of the numerous cases where there have clearly been governance issues, there is little or no explanation. Where the nominee director has stepped down, an explanation as to the reasons is not always provided even though this may be significant as it may be due to dissatisfaction, disagreement or due to the ineffectiveness of the nominee director. Given the reliance on the nominee director to secure transition impact, paying proper attention to the outcomes of the appointment and developments in the role being played represents a significant opportunity to strengthen delivery of transition impact.

The Corporate Equity team has an initiative in process to introduce documented board engagement objectives and retrospective self-appraisal by nominee directors for the 35 external nominee director positions in the corporate sector (non-financial institutions sector) funded by the EBRD budget line. It is too early to assess the impact of the process but it is a step in the right direction and Corporate Equity comment that it has been well received by nominee directors. If successful, and once the approach and process has been put into operation and institutionalised, the approach should lend itself to implementation across all nominee director positions and becoming embedded within business teams (as against being managed directly by Corporate Equity at present, which could continue to provide advisory support). A more systematic approach to nominee director objective setting would lend itself to integration with strengthened value creation, transition impact and monitoring approaches. As a general observation, objectives will need to be consistent with the principles which an independent non-executive should be pursuing (unlikely to be an issue for the EBRD). The way in which objectives are set for EBRD appointees will need to be nuanced for aspects such as specific roles (such as the audit committee chairman) and retain a reasonable degree of flexibility – things can change quickly in EBRD investee companies and it may be necessary to review specific objectives mid-year. Flexibility may also be needed at appraisal – a conscientious and effective nominee director may make no headway on their objectives due to factors beyond their control. In a complementary initiative Portfolio Management has recently introduced guidelines for operation leaders and data tracking tools to support the exercise of the EBRD’s shareholder voting rights. This area was previously overlooked in the equity management process and was largely left to the discretion of operation leaders who, without guidance, would sometimes not exercise voting rights and risk sending contradictory messages to the nominee director concerning governance and accountability.

It is also the case that the limited sample may understate the Board engagement that takes place with nominee directors. For example, study documents for the Financial Institutions sector sample of three banks generates a picture of investments that took place in difficult circumstances and had limited board level impact. Including gaps in the reporting of nominee directors’ engagement and governance. Banking has pointed out, by comparison, the successful nominee director engagement with Client P on the institution building plan, governance and value creation (Client P is one of the largest investments in the study population and has experienced a significant growth in book value. Client P was not included in the sample). It may also be that that this type of interaction is captured in tailored Financial Institutions sector documents that were not part of the core document set used for this study. This potential variance should be noted but it does not change the overall finding that more needs to be done to integrate nominee director board interaction into the value creation and transition processes.

Other findings from analysis of the sample are:

- In numerous cases there was a delay in getting the nominee director onto the board (although it is recognised that this may have to await a shareholder meeting). This type of issue should be surfaced during corporate governance due diligence
- In only one case is the target profile of the nominee director set out.
2.2.4 Nominee director interaction examples

- Client E: objectives for the nominee director were set out but no follow-through on progress is evident from monitoring documents (Client T being the only other case of objectives being set out).
- Client EC: an attempt was made (uniquely) to set out the required profile of the nominee director.
- Client L: a lack of emphasis on finding and appointing the right nominee director subsequently had significant consequences as serious governance issues arose (later addressed by the appointment of a senior EBRD nominee director)
- Client MM: no explanation is provided as to why the nominee director departed.

Measures for improvement

- Set out a target profile for each nominee director appointment aligned against governance and value creation priorities for the investment. Undertake a risk assessment of gaps between the profile of the appointee and the target.
- Require specification of generic and investment-specific objectives for each nominee director (including when an EBRD internal appointment)
- Monitor and record the effectiveness of the nominee director engagement against the objectives. Establish a process that ensures accountability for both EBRD and nominee director performance under the nominee director engagement
- Incorporate a summary of the nominee director’s reports into the monitoring reports (subject to confidentiality restrictions)

2.3 Risk assessment

Risk assessment good practice 1

Rigorous risk analysis including:
- consistent evaluation of the political and regulatory risks;
- effective consideration of operational risks;
- relevant and precise description of the corresponding mitigants, mitigating actions and residual risk after mitigation

2009 findings

Risk analysis presented in Board documents needed to be enhanced. Management commented that the standard had now reached an appropriate balance between risk identification/analysis and the need to maintain a tight focus on the important issues, keeping the final review memorandum / Board document to a reasonable length. Management also commented that ‘boilerplate’ risk assessment (as found in offering memoranda) was to be avoided; more detailed analysis could be discussed between the team and Credit department.

Ex ante analyses of non-financial risks in the sample was improved in some respects. The list of risks assessed is more extensive than found in the 2009 Study and some operational risks are included more frequently. The risk analysis is better structured. However, issues concerning risk assessment arose frequently amongst sample investments. Only one investment (Client RG) was identified as having strong risk analysis; two-thirds (12) were reasonable (but with deficiencies) and four presented with issues in the
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approach to risk assessment, including Client CP, Client GP and Client L which all subsequently ran into difficulty.

Risk analysis often presented limited linkage to the risks identified. In only one-third (six) cases was linkage between the two discernible. For the reader to make an assessment of the quality of the equity story, the risk considerations need to be factored in: how achievable is securing the value driver given the risks?

The main issue concerning risk assessment continued to be the quality of the description of the mitigants. In some cases, it is difficult to discern the relevance of the mitigant to the risk identified. In many others, the ‘mitigant’ is more a description of why the risk is not significant or less likely to crystallise than a description of the mitigating actions (referred to in the 2009 evaluation study as ‘mitigating away the risk’).

While this may be valid, the risk response should state where a response is not required or not possible. The risk analysis could be structured such that a ‘risk response map’ can be developed to show clearly what steps are being taken to reduce the risk profile. Consideration should also be given to identifying key risk indicators (measures which indicate whether the probability of crystallisation is increasing or decreasing) and incorporate the indicators in the monitoring process.

The risk of a negative political impact on transition and value creation will apply in many cases but political risks were identified clearly in only three cases. Assessment of political risks (including regulatory risks that are political in origin) is crucial to identifying potential obstacles to success. Overcoming these risks (or at least trying to dilute their impact) should be reflected in the risk analysis and incorporated in the approach to transition impact.

Measures for improvement

- Develop a more rigorous risk analysis model to provide guidance, particularly in relation to political risks and operational risks across the full spectrum. Reflect risk analysis in the approval documents;
- Re-orientate the approach in Board documents to identify mitigating actions to be taken rather than a narrative about factors which reduce the gross risk;
- Consider the development of risk key performance indicators.

Risk assessment good practice 2

Drawing effectively on lessons learnt including:

- Selecting lessons that are relevant and not limited to the same industry sector;
- Ensure that the ‘response’ to the selected lessons is relevant and the consequences are either reflected in the analysis/plan or the ‘rejection’ of the learning is explained.

The Lessons Learnt analysis is a step forward from previous practice. However, often the lessons search has been limited to lessons from investments in that sector (or sub-sector), rather than lessons that reflect the substance of the operation or project (for example the dangers of relying on an initial public offering for exit and the degree of regulatory risk).

The analysis often appears to result in an explanation as to ‘why this doesn’t apply to us’ rather than a well-thought through response to what might need to be factored in (for example, to pricing or governance approach) in order to make sure the learning or risks are addressed. In this sense, it is an extension of the risk mitigation approach and a missed opportunity.
2.3.1 Lesson examples

- Client G: the lessons selected were largely irrelevant; they were limited to the rail sector and failed to incorporate lessons on other initial public offerings (regardless of sector);
- Client L: relevant lessons did not receive the response they merited;
- Client VG: a key lesson around the mix of debt and equity in projects supported by individuals was summarily dismissed.

Measures for improvement

- Identify leanings early and consider how the transaction structure might be modified to mitigate financial risk and enhance transition impact;
- Ensure lessons include similar structures outside the particular sector;
- Apply focus on mitigating actions that help reduce risks or size opportunities identified by the lessons;
- Develop with EvD a ‘generic lessons’ guide on key thematic topics.

3. Conclusions, issues for further consideration and recommendation

3.1 Conclusions and issues for further consideration

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

- The process for review of the equity portfolio and individual investments (including exit considerations) is much improved and supported by more useful information and better interaction between departments on exit readiness from a transition perspective.
- Substantial progress has been made on portfolio and investment financial performance monitoring (highly linked to establishment of the Equity Portfolio Management Unit).
- Substantial progress has been made in the way financial and strategic analysis and commentary is presented in approval documents for individual investments.
- Enhanced efforts are evident in other areas such as risk analysis and the setting of equity related measurable benchmarks (in the transition impact monitoring system).

Other initiatives currently in process (establishing value creation plans and developing an approach to corporate governance due diligence and monitoring) will contribute further to the progress made and need to be pushed to a conclusion.

These are all steps in the right direction but findings from this study raise important issues concerning equity investment for further consideration by the Board and Management of the EBRD. Most significant are issues highlighted by this study in the tools, processes and practices for investment and monitoring at the level of the individual investment.

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

- The equity approach lacks a clear emphasis on value creation from pre investment to exit and is undermined by the monitoring report structure. The main sources and drivers of value creation need to be clearly identified and integrated with both post-investment monitoring and with transition impact. Management anticipates that the newly-developed approach to value creation plans introduced in 2012 will go a long way to correcting this but this remains to be seen.

- Monitoring reports and the automated project monitoring system, are no longer fit for the purpose of equity monitoring. The system review which is underway needs to be supported to a practical conclusion. It is arguable that a fresh start is needed in equity monitoring as the current approach is not generating effective monitoring in a coherent and structured way. Monitoring challenges, difficult under most circumstances, are made even more so by an investment process that does not explicitly define expected equity results ex ante in a way that is integrated across the EBRD. This is most pronounced in the areas of sound banking and transition impact - sound banking dimensions such as investment returns and risk management are closely linked with transition dimensions such as corporate governance and competitiveness. Though linked, the EBRD both designs and manages these aspects under separate internal processes and results frameworks.

- Despite the heavy emphasis on governance underpinning the additionality for EBRD equity investment (dual role in value creation and transition), this is still not reflected in the approach to due diligence or documentation of issues and opportunities in the final review memorandum, Board document or monitoring reports. Important work is in progress around introducing templates and approaches to governance due diligence but this has yet to be applied operationally as a standard and integral part of pre-investment assessment and on-going monitoring. Senior management support will be needed to drive this to full implementation.

- There are questions around the effectiveness of engagements with nominee directors, related to a transparent and documented process of setting and monitoring nominee director objectives and performance. Further development of the approach is required to ensure nominee director appointments are integral to value creation and monitoring and that appointment of nominee directors is accompanied with the setting of clear objectives, performance indicators and an appraisal process.

The equity investment portfolio now represents the most volatile component of the EBRD’s financial results. The main reports for communicating aggregate equity results to the EBRD’s Board are the quarterly financial performance and risk reports. Although the equity content of these reports has certainly improved in recent years they are arguably risk, rather than performance orientated. The set of governance questions a Board would typically want to be in a position to answer might be summarised as:

- What are we aiming to achieve?
- What do we have to get right?
- How do we encourage strong performance?
- How do we know we are getting it right?
- How does this position us for the future (and what do we need to do to prepare)?
3.2 Recommendations

This study presents a large number of suggested measures for improvement. These are intended to stimulate and encourage debate over how to strengthen the EBRD’s approach to equity investment. The suggestions are not intended to be prescriptive recommendations. However, a number of recurring and interlinked themes emerge from the report around:

- The need to place value creation and the equity narrative at the heart of the investment approach from pre-investment assessment to exit. Doing so would enhance the results focus and related accountability.

- The opportunity to draw together the multiple internal stakeholders involved in equity investment often with overlapping interests or differentiated approaches to value creation, transition and monitoring. Establishing a unified approach to equity across internal stakeholders would encourage more consistency through the life of an investment and maximise opportunities for learning and sharing of best practice.

- The imperative to re-think the equity monitoring approach, process and tools in a way that focuses on objectives and results from investment to exit.

Drawing these common themes together, the study makes three recommendations:

3.2.1 Review the EBRD’s equity approach

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

3.2.2 Review the post investment equity monitoring process and reporting

The 2009 Organisational Capacity Review recognised that in an ideal world the equity monitoring process and tools would not be designed the way they are. There is a strong argument to say the monitoring process should be redesigned from scratch. In practice, as emphasised by Portfolio Management, equity management needs to be seen in the context of a broader and on-going review of portfolio management, in which process enhancements must serve multiple users and it is therefore difficult to single out equity for a tailored approach within the EBRD. Within the limits of the institutional context, it is recommended that the equity monitoring report and reporting process is redesigned. As a first step the monitoring process needs to be reviewed, in conjunction with the equity investment business process, to define the requirements the monitoring report needs to fulfil for the multiple stakeholders it serves. It should be left for the review to determine how the monitoring process and reporting format needs to be developed but it is clear that there are complex and interlinked dimensions that will need to be considered and it is likely that implementation budgets may be required to implement a further significant change in the way equity is managed. It may yet be concluded that the monitoring report needs to be refocused around a smaller number of equity results, value creation drivers and key performance indicators, rather than to try and satisfy multiple users in multiple ways as at present.
3.2.3 Modernise Board documents for equity content

It is recommended that the working group reviewing the final review memorandum / Board document template incorporate equity specific elements into any new format considered. As a minimum, the equity content should reflect current initiatives in Banking to introduce value creation plans for all equity investments and enhanced corporate governance approaches. These two elements alone provide an opportunity to strengthen the results framework presented in the Board document but a wider opportunity exists to present the equity story as a more accessible, better signposted narrative that brings clarity to the drivers of value creation, interdependencies, expected results, risk factors (and for the final review document, their impact on valuation).
Annex 1: Study population and sample

Overview

This Study is based on analysis of a sample of equity projects signed in the period from the 1st January 2007 to 30th June 2011. The review period was selected specifically to capture initiatives in equity management implemented by the EBRD in this period. The study population was structured to identify direct equity investments where the project rate of financial return to the EBRD was dependent on commercial and financial performance of the investment. The population excludes:

- Equity funds;
- Investment under frameworks, such as the Direct Investment Facility and Local Enterprise Facility;
- Investments with a fixed, debt related return profile through equity put / call arrangements (‘portage equity’).

A population of 116 projects was identified as relevant to the study. Reflecting a combination of recent vintage and market conditions, only four of the 116 Study population investments had been fully or partially exited, with one other investment exited by write off. At the cut-off date there was an insufficient population of exited investments to undertake a study of equity exits and this has been influential in finalising the study focus.

Population and sample

The study population of 116 projects represented investments with an original cost of €2.5 billion and a fair value at 30 June 2011 of €2.4 billion. An initial sample of 20 investment, subsequently reduced to 17, was selected for detailed analysis. The sample was chosen on a purposive basis. Selection criteria included:

- mix of sector, geography, size and vintage;
- inclusion of some exited investments;
- inclusion of investment resulting in corporate recovery involvement;
- inclusion of evaluated investments where a desk assessment or detailed Operation Performance Evaluation Report had been completed by Evaluation Department;
- inclusion of a range of transition impact achievement;
- mix of ownership and sponsor types (listed; local owner; global sponsor; regional sponsor);
- screening discussions with Corporate Equity, Portfolio Management and Financial Institutions to identify investments of interest and verify the final sample. The final sample was also screened with Corporate Recovery and Internal Audit for no objection.

The sample of 17 investments had the following aggregate profile:
Table 1

<table>
<thead>
<tr>
<th></th>
<th>Sample</th>
<th>Population</th>
<th>Sample as % of Population</th>
</tr>
</thead>
<tbody>
<tr>
<td>Project Count</td>
<td>17</td>
<td>116</td>
<td>15%</td>
</tr>
<tr>
<td>Original Cost</td>
<td>€682 million</td>
<td>€2.5 billion</td>
<td>27%</td>
</tr>
<tr>
<td>Fair Value 30 June 2011</td>
<td>€891 million</td>
<td>€2.4 billion</td>
<td>37%</td>
</tr>
</tbody>
</table>

The combination of small total population and resources available led to sample selection, as already stated, on a purposive basis. The sample is neither a portfolio nor statistically representative random selection. Selection was made specifically to capture a range of projects by size, geography, vintage and evaluation, corporate recovery and exit status. The sample has nevertheless reflected some overall population characteristics, particularly by sector and vintage but less so geographically. Table 2 summarises the weighting of the sample, against weighting in the total population with an original cost of €2.5 billion for 116 investments (Table 2).

Table 2

<table>
<thead>
<tr>
<th>Country</th>
<th>Sample by value</th>
<th>As % of sample</th>
<th>category as % of population</th>
<th>Sample by number of projects</th>
<th>As a % of sample</th>
<th>category as % of population</th>
</tr>
</thead>
<tbody>
<tr>
<td>Croatia</td>
<td>43,040,922</td>
<td>6%</td>
<td>3%</td>
<td>2</td>
<td>12%</td>
<td>3%</td>
</tr>
<tr>
<td>Georgia</td>
<td>38,404,453</td>
<td>6%</td>
<td>2%</td>
<td>2</td>
<td>12%</td>
<td>3%</td>
</tr>
<tr>
<td>Hungary</td>
<td>50,000,000</td>
<td>7%</td>
<td>2%</td>
<td>1</td>
<td>6%</td>
<td>3%</td>
</tr>
<tr>
<td>Moldova</td>
<td>1,945,448</td>
<td>0%</td>
<td>0%</td>
<td>1</td>
<td>6%</td>
<td>2%</td>
</tr>
<tr>
<td>Mongolia</td>
<td>14,286,803</td>
<td>2%</td>
<td>1%</td>
<td>1</td>
<td>6%</td>
<td>6%</td>
</tr>
<tr>
<td>Poland</td>
<td>48,557,559</td>
<td>7%</td>
<td>5%</td>
<td>1</td>
<td>6%</td>
<td>3%</td>
</tr>
<tr>
<td>Regional</td>
<td>15,000,000</td>
<td>2%</td>
<td>18%</td>
<td>1</td>
<td>6%</td>
<td>15%</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>408,108,373</td>
<td>60%</td>
<td>44%</td>
<td>5</td>
<td>29%</td>
<td>29%</td>
</tr>
<tr>
<td>Serbia</td>
<td>40,000,000</td>
<td>6%</td>
<td>2%</td>
<td>1</td>
<td>6%</td>
<td>2%</td>
</tr>
<tr>
<td>Ukraine</td>
<td>22,618,644</td>
<td>3%</td>
<td>9%</td>
<td>2</td>
<td>12%</td>
<td>12%</td>
</tr>
</tbody>
</table>

681,962,201 100% 17 100%

<table>
<thead>
<tr>
<th>Sector</th>
<th>Sample by value</th>
<th>As % of sample</th>
<th>category as % of population</th>
<th>Sample by number of projects</th>
<th>As a % of sample</th>
<th>category as % of population</th>
</tr>
</thead>
<tbody>
<tr>
<td>Energy</td>
<td>268,368,577</td>
<td>39%</td>
<td>24%</td>
<td>5</td>
<td>29%</td>
<td>21%</td>
</tr>
<tr>
<td>Financial Institutions</td>
<td>178,315,419</td>
<td>26%</td>
<td>26%</td>
<td>4</td>
<td>24%</td>
<td>30%</td>
</tr>
<tr>
<td>ICA</td>
<td>203,398,967</td>
<td>30%</td>
<td>31%</td>
<td>7</td>
<td>41%</td>
<td>41%</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>31,879,238</td>
<td>5%</td>
<td>19%</td>
<td>1</td>
<td>6%</td>
<td>9%</td>
</tr>
</tbody>
</table>

681,962,201 100% 17 100%

<table>
<thead>
<tr>
<th>Vintage</th>
<th>Sample by value</th>
<th>As % of sample</th>
<th>category as % of population</th>
<th>Sample by number of projects</th>
<th>As a % of sample</th>
<th>category as % of population</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>405,356,675</td>
<td>59%</td>
<td>39%</td>
<td>7</td>
<td>41%</td>
<td>35%</td>
</tr>
<tr>
<td>2008</td>
<td>110,936,797</td>
<td>16%</td>
<td>17%</td>
<td>4</td>
<td>24%</td>
<td>21%</td>
</tr>
<tr>
<td>2009</td>
<td>88,127,807</td>
<td>13%</td>
<td>18%</td>
<td>4</td>
<td>24%</td>
<td>21%</td>
</tr>
<tr>
<td>2010</td>
<td>77,540,922</td>
<td>11%</td>
<td>21%</td>
<td>2</td>
<td>12%</td>
<td>19%</td>
</tr>
</tbody>
</table>

681,962,201 100% 17 100%

<table>
<thead>
<tr>
<th>Equity type</th>
<th>Sample by value</th>
<th>As % of sample</th>
<th>category as % of population</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>284,044,675</td>
<td>42%</td>
<td>27%</td>
</tr>
<tr>
<td>2</td>
<td>82,807,940</td>
<td>12%</td>
<td>27%</td>
</tr>
<tr>
<td>4</td>
<td>42,585,066</td>
<td>6%</td>
<td>13%</td>
</tr>
<tr>
<td>5</td>
<td>272,524,520</td>
<td>40%</td>
<td>30%</td>
</tr>
</tbody>
</table>

681,962,201 100% 17 100%
Sample

<table>
<thead>
<tr>
<th>Client</th>
<th>Industry</th>
<th>Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>VG</td>
<td>Agribusiness</td>
<td>Serbia</td>
</tr>
<tr>
<td>O</td>
<td>Financial Institutions group</td>
<td>Russia</td>
</tr>
<tr>
<td>RG</td>
<td>Insurance &amp; Financial Services</td>
<td>Russia</td>
</tr>
<tr>
<td>MM</td>
<td>Natural resources</td>
<td>Mongolia</td>
</tr>
<tr>
<td>T2</td>
<td>Power &amp; Energy</td>
<td>Russia</td>
</tr>
<tr>
<td>PI</td>
<td>Manufacturing &amp; Services</td>
<td>Regional</td>
</tr>
<tr>
<td>G</td>
<td>Transport</td>
<td>Russia</td>
</tr>
<tr>
<td>M</td>
<td>Financial Institutions group EU &amp; Ukraine</td>
<td>Ukraine</td>
</tr>
<tr>
<td>CP</td>
<td>Natural resources</td>
<td>Ukraine</td>
</tr>
<tr>
<td>MW</td>
<td>Power &amp; Energy</td>
<td>Hungary</td>
</tr>
<tr>
<td>GP</td>
<td>Property &amp; Tourism</td>
<td>Georgia</td>
</tr>
<tr>
<td>AG</td>
<td>Agribusiness</td>
<td>Croatia</td>
</tr>
<tr>
<td>E</td>
<td>Power &amp; Energy</td>
<td>Poland</td>
</tr>
<tr>
<td>T</td>
<td>Financial Institutions group Central Asia, Caucasus, Mongolia</td>
<td>Georgia</td>
</tr>
<tr>
<td>SC</td>
<td>Telecoms, Informatics, Media</td>
<td>Moldova</td>
</tr>
<tr>
<td>EC</td>
<td>Manufacturing &amp; Services</td>
<td>Croatia</td>
</tr>
<tr>
<td>L</td>
<td>Agribusiness</td>
<td>Russia</td>
</tr>
</tbody>
</table>

Review process and core documents

Sample analysis is based on consistent review of a common set of documents. The document set reviewed for each investment comprised:

**Approval documents**

- Final review memorandum and term sheet
- Integrity check
- Final review memorandum support unit comments to the Operations Committee
- Final review memorandum Operations Committee Minutes

**Board and signing**

- Board document
- Board Directors’ Advisors’ questions
- Board minutes
- Key legal docs – including subscription agreement, shareholders agreement, options
Monitoring

- First and most recent monitoring report (including financial attachments and valuations)
- First and most recent credit review summary
- First and most recent Transition impact monitoring system report

Note: Value creation plans and nominee director reports were not included for operational reasons

Ex-post

- Expanded monitoring report / assessment (XMR/A)
- Operation performance evaluation report
- Exit information note

EBRD corporate documents

- Operations manual
- Quarterly risk report
- Nominee director training

For various operational reasons, value creation plans (for investments by the Financial Institutions business group, other business groups only starting adoption in 2012) and nominee director reports were not available to the study. Perspectives were obtained through combination of survey and collective interview comment.

The document review template (Annex 2), was designed around the three phases of the equity cycle – entry, post investment management / value creation and exit. For each of these phases, the issue or opportunity for improvement identified in the Evaluation department’s ‘Equity exits’ study was presented for comment under the template for each investment under this study sample. Inevitably completion of the template involves judgements but the purpose of the template is to introduce a sufficient level of consistency and a sufficient number of evidential cases, to support the findings and recommendations of this study.
Annex 2: Template & example for equity assessment

<table>
<thead>
<tr>
<th>Country</th>
<th>Regional</th>
<th>Timing</th>
<th>December 2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sector</td>
<td>Retail</td>
<td>Sponsor</td>
<td>Icelandic owners</td>
</tr>
<tr>
<td>Purpose</td>
<td>Addition of new pharmacies (acquisitions; organic growth)</td>
<td>Board</td>
<td>One Nominee Director; veto rights</td>
</tr>
<tr>
<td>Ownership</td>
<td>Listed?</td>
<td>Transition impact</td>
<td>Satisfactory; Medium</td>
</tr>
<tr>
<td>Overall Risk Rating</td>
<td>6-6W</td>
<td>Exit</td>
<td>Trade sale or Initial public offering; 5 to 7 years; Put, Tag/Drag Along</td>
</tr>
<tr>
<td>Environmental</td>
<td>6 (multiple)</td>
<td>Other</td>
<td>€15 million - 20 per cent increasing to 27 per cent (sponsors € 40 million); internal rate of return 28.1 (21.7 risk assessed)</td>
</tr>
</tbody>
</table>

**Issue (2009)**

**ON ENTRY**

**Use of equity (versus credit) to secure Transition impact**

**More focus on Transition impact assessment and additionality**
Benchmarks set out but CG a mix – mainly they relate to IFRS and management development. Competition objectives reasonable. Need for work on transition impact benchmarks (Office of the Chief Economist) – but no changes fed through to Board document.

**Articulation of exit strategies**
Weak

**Basic financial and strategic analysis**
Reasonable but concerns raised by both Credit department (cross-border/growth feasibility) and by Board over how realistic the plans are based on the limited and small country experience of the Sponsor.

**Linkage – risk, IRR, pricing, decision**
Deterioration in Put counterparty quality since Structure Review noted by Credit. Is internal rate of return risk assessment used? Specified in some places, not in others.

**Exit horizons factored into pricing**
Not evident – just flexing of forecasts over 2007-12

**Hurdle rates**

**Assessment of management**
Brief but supposedly based on thorough assessment.

**Risk analysis**

**Governance issues as part of monitoring/objectives**
Poorly set out – unclear

**Improved nominated director approach**
Expectations not clear
## DURING LIFE

**Progress reporting**
Project monitoring system report 10/08. Constrained by delays in IFRS audit and consolidated reporting but operational data reasonable. Series of qualified opinions from KPMG “due to late appointment” resulting in scope restrictions – but not discussed whether there were wider issues.

**Tie in to risks**
Limited – not explicit

**Delayed exit**
n/a

**Focus on exit (regular review)**
n/a – went to corporate recovery in May 2009

**Justification of capital increases and rights**
n/a

**Equity management culture; focus on value creation**
Project monitoring system report 10/08 Limited comments of management - some assessment but difficult to form a view
Some discussion of value creation – but mainly simply a repetition of entry narrative at this stage

**Transition impact monitoring**
OK versus benchmarks but CG limited to structural comments
Project monitoring system report 10/08 assessments do not tie in with concerned comments from Credit department: assessment against benchmarks give a false impression?

**Nominated Director**
Ex-employee; not on AC; no information in Project monitoring system report 10/08
Note of nominee director’s visits to operations
Operation leader attendance as an observer
Unclear - why does Project monitoring system 12/11 say “intentionally kept in breach” re Nominee Director and Sup Board meetings
Resigned Dec 09 on winding-up

**Reporting to Board; transition impact; exit progress**
Project monitoring system report 10/08: Why is IFRS described as on track given the problems with qualified opinions and delays?

## ON EXIT

**Premature exit undermining transition impact achievement**

**Assessment of transition impact on exit; improved exit approval memos/info notes**
n/a

**Integrity of buyer**
n/a

**Future governance strategy**
n/a

**Benefit of drip feed**
n/a

## OTHER ISSUES

**High expectations of transition impact on entry - overly optimistic?**
Assessment possibly poor in general as it hinged on credibility of Sponsor

**Shift in transition impact emphasis onto governance, standards and transparency (away from competition, demonstration effects)**
Not evident and not followed through

**Capturing and application of learnings**
None

**Measurability/clarity of objectives/success criteria – tracking into operational management**
Poor – lost in maze of multiple-country over-simplification
<table>
<thead>
<tr>
<th>Focus on value creation in proposal</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increased emphasis on governance</td>
<td>No</td>
</tr>
<tr>
<td>Better communication with nominated directors (alignment with operation leader; Terms of reference; Guidance Note) – but follow-up?</td>
<td>Difficult to tell</td>
</tr>
<tr>
<td>Better tracking through Equity Portfolio Monitoring Unit</td>
<td>Poor – assessments diluted by multi-country approach leading to superficial presentation</td>
</tr>
<tr>
<td>More structured approach to exits through the Equity Committee</td>
<td>n/a</td>
</tr>
<tr>
<td>Limited discussion around exit opportunities (for example with banks/buyers)</td>
<td>n/a</td>
</tr>
<tr>
<td>Exit reporting – Internal rate of return divergence and outcomes commentary</td>
<td>n/a</td>
</tr>
<tr>
<td>Telling the Equity story</td>
<td>Not evident</td>
</tr>
</tbody>
</table>

**Reflections**

- Why was company wound up in December 2009? Project monitoring system report 12/11 valueless
- Corporate Recovery from May 2009
- Learnings?
- Incomplete picture. What happened after Project monitoring system report 10/08? Where was the monitoring after that?
- Should Board question about the credibility of Sponsor have been taken more seriously?
- Difficult to tell without more information on what went wrong.
Annex 3: Summary findings from sample analysis

The following three tables present data aggregated and summarised from the file reviews.

Table 1 presents the 17 investments reviewed in the columns, against a summary set of equity related issues identified in the 2009 report, presented in the rows. Table 1 aggregates findings from the file reviews and presents them with ‘traffic light’ colour coding. Green represents good progress or good practice and red represents areas that are still an issue and much could be done to strengthen practice. The issue set has been mapped from Annex 2, in some cases reformatted, reworded or aggregated for ease of presentation. The purpose of this table is to draw attention to areas where practice is weakest, around governance, pricing, management assessments monitoring for value creation and nominee director reporting.

Table 2 is identical to Table 1 but includes a summarised finding for each issue and for each investment reviewed. These findings are based on data collected under Annex 2. Table 2 is presented over three pages.

Table 3 presents other information collected from file reviews but not directly related to the 2009 issue set but nevertheless of interest or relevance to this Study. A series of examples are also presented. Table 3 is presented over 3 pages.

References to TI are to ‘transition impact’.
### EQUITY INVESTMENTS: SUMMARY ASSESSMENT

<table>
<thead>
<tr>
<th>Case 1</th>
<th>Case 2</th>
<th>Case 3</th>
<th>Case 4</th>
<th>Case 5</th>
<th>Case 6</th>
<th>Case 7</th>
<th>Case 8</th>
<th>Case 9</th>
<th>Case 10</th>
<th>Case 11</th>
<th>Case 12</th>
<th>Case 13</th>
<th>Case 14</th>
<th>Case 15</th>
<th>Case 16</th>
<th>Case 17</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>BEFORE ENTRY</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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Special Study: Achieving equity investment objectives: A review of initiatives since 2007
Achieving equity investment objectives: A review of initiatives since 2007

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**Before Entry**

- Improved strategic and financial analysis
- Superior transparency
- Less reliance on IFRS
- Better articulation of exit horizons
- More rigorous risk analysis
- Increased focus on monitoring
- More insightful assessment of pricing

**2007**

- Improved strategic and financial analysis
- Superior transparency
- Less reliance on IFRS
- Better articulation of exit horizons
- More rigorous risk analysis
- Increased focus on monitoring
- More insightful assessment of pricing

**2009**

- Improved strategic and financial analysis
- Superior transparency
- Less reliance on IFRS
- Better articulation of exit horizons
- More rigorous risk analysis
- Increased focus on monitoring
- More insightful assessment of pricing
Table 4: Seventeen study sample investments and other relevant findings

Abbreviations

AC- Audit Committee
CEO- Chief Executive Officer
CG- Corporate Governance
CR- Corporate Recovery unit
EAP- Environmental Action Plan
EMR- Equity monitoring report
IPO- Initial public offering
IRR- internal rate of return
KPI – key performance indicators
MI- Management information
MR- monitoring report
ND- Nominee Director
OCE- Office of the Chief Economist
RC- Risk committee
TA- Technical assistance
TI- Transition impact
TIMS- Transition impact monitoring system
VC-
## EQUITY INVESTMENTS: SUMMARY ASSESSMENT

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### EXAMPLE

**Lack of focus on key risks**

- **Lack of response to OCE**
- Specification of governance objectives weak
- Key risk (permit) not considered
- Poor management assessment - over-reliance on credit/parent relationship
- Weak, confused justification of additionality and TI.

**Poor corporate governance assessment with ineffective benchmarks**

- Poor assessment of management
- Heavy emphasis on Supervisory Board but failure to think through membership and degree of influence
- Weak prior specification of ND profile
- Weak approach to considering corporate governance on entry
- Confusion over OCE "compliance with Code" meaning? Did the team understand this?

**Confusion over TI on strategic commercial**

- Poor response on risks to Credit and OCE
- AC and RC requested but taken outside of political and governance context
- Inadequate assessment of management capabilities
- Poor corporate governance creates problems but little evidence of understanding
- Poor use of lessons, Limited to rail and largely irrelevant. What about other IPOs? Need for ND? Credit "political interference remains unmitigated" Relevant one (need for a seat) ignored.

**MR poor except financial analysis, careless; poor coverage**

- Significant management issues and changes but little explanation
- ND objectives set out but then no follow through
- Lack of basic financial management skills not identified
- Inadequate narrative as problems start emerging
- TI case and additionally needed but on governance and ND but ND found to be a chimera.

**Poor monitoring - big shifts with no explanation**

- Monitoring better than in most VC monitoring improves later
- Positive EMR 2011 - but then in CR within 6 months
- Daily conference calls - why???
- Failure to monitor governance issues/highlight questions. Delays not challenged (eg EAP minority interest policy)

**Detailed governance benchmarks but "trices" with subsequent issues**

- Governance intent evident but no discussion or follow through
- TI over-emphasis on commercial objectives and demonstration
- CG used as a justification for additionality but then left unclear. Diminished in importance when it Rashed - and resultant weaknesses evident

**Poor risk analysis - political risk neglected**

- Adequacy of 2 weeks’ due diligence

**Benchmark in TIMS - how can you see "compliance with OECD principles achieved" - meaning?**

- Management issues but no discussion (CEO dismissed)
- Advisor’s questions dismissed eg Board makeup

**Additionally, Not mentioned in prospectus but subsequent reference to comfort from EBRD participation**
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- Questionable
- Sound
- Sound
- Sound

Compensation TI obj
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- Yes
- Yes
- No
- No

Governance Policy obj
- No
- Yes
- No
- No
- No

Governance Structure
- No
- No
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- No
- No

IFRS reporting existing
- Yes
- No
- No
- But a target
- No

Internal ND
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- Yes
- Yes
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- Yes

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- No
- No

TA
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- No
- No
- Yes
- No

Global sponsor
- No
- Yes
- No
- Yes
- Yes

Political risk identified
- No
- No
- Yes
- Yes
- No

EXAMPLE
- Poor responses to OCE request for expansion on CG development/plant only refs to ND and AC membership. Also poor response to Advisor re ND app.
- No OCE reference to CG - focused on demonstration effect.
- Credit identifies need to assess viability of counterparty to honour Put but not clear whether this was assessed.
- OCE expresses concerns over Monnis but not addressed in Board doc.
- Says CG is a key theme but then does nothing to expand on it. Clear lack of understanding.
- Poor assessment of management and governance has significant ramifications. Over-reliance on existing relations and perceptions of strength.
- No reference to Parent’s CG policies - suggests a lack of attention or understanding.
- Credit concern over the expected return which is seen as over-optimistic and also over expected length of holding - but unchanged in final document.
- TI monitoring good although it is not clear why TIMS analysis changes (for the better) with new risks being introduced.

Good scenario analysis. TIMS report on objectives does not accurately tie into benchmarks. Corporate governance assessment not evident.
- Operational risk analysis poor with little consideration of risk management systems.

Shareholder risk identified but dismissed as “low/medium”. In general risks not addressed with mitigants but instead are dismissed.
- Weak discussion of value creation in monitoring even as delays kick in. Not updated in any meaningful way.
- Nothing on CG (nos benchmarks) even though CG given as a clear justification for add.

Lessons do not receive adequate responses.
- Corporate governance statements ill-founded and poorly thought through. Then not followed through.
- Lack of clarity around expected IRRs - figures differ and keep changing for unclear reasons.

Credit concerns about pricing and valuation seemingly dismissed. Also Equity note concerns about high value sector.
- Environmental risks of strong but then withers during reporting.
- Tracking against TI benchmarks confused as MR and TIMS adopt different approaches and information not updated.

Political risk identified No Yes Yes No No

What role was ND playing before L. Forbes rescue?
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<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Valuation basis</td>
<td>Good</td>
<td>Good</td>
<td>?</td>
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<tr>
<td>Risk-adjusted IRR</td>
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<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Range of target exit dates</td>
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<td>Yes</td>
<td>?</td>
</tr>
<tr>
<td>Financial influencing event</td>
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</tr>
<tr>
<td>Additiveness</td>
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<td>Questionable</td>
</tr>
<tr>
<td>Competence Ti obj</td>
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<td>Yes</td>
</tr>
<tr>
<td>Governance Policy obj</td>
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<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Governance structure</td>
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<td>No</td>
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</tr>
<tr>
<td>IFRS reporting existing</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Internal ND</td>
<td>Not appointed</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>MI to Board considered</td>
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<td>No</td>
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</tr>
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</tr>
<tr>
<td>Global sponsor</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Political risk identified</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

EXAMPLE
Weak, confused justification of additiveness and Ti.

Poor response to OCE request for separation on CG development plan - only role to ND and AC membership. Also poor response to Advisor re ND appointment.

No OCE reference to CG - focused on demonstration effect. Credibility need to assess additiveness of counterparty to honour put but not clear whether this was assessed.

Confusion over CG "compliance with Code" meaning? Did the team understand the?

Poor assessment of management and governance has significant limitations. Over-reliance on existing relations and perceptions of integrity.

No reference to Parent’s CG policies - suggest a lack of attention or understanding.

Credit concern over the expected return which is seen as over-optimistic and also over extended length of holding - but unchanged in final document. Ti monitoring good although it is not clear why Ti analysis changes for the better with new risks being introduced.

Poor use of phrases. Limited to roll and largely dismissive. What about other IPOs?
Need for ACP? Credit: "political interference means unmitigated". Relevant one noted for a weak position.

Good scenario analysis.

TIMS report on objectives does not accurately tie into benchmarks. Corporate governance assessment not existent.

Operational risk analysis poor with little consideration of risk management systems. No discussion as to why original ND left.

Reduce and additively raised heavily on governance but ND role ND proved to be a chimera.

Shareholder risk identified but dismissed as “balanced”. In general risks not addresses with mitigates but instead are "diluted".

Weak discussion of value creation in monitoring ever as delays kick in. Not updated in any meaningful way.

Nothing on CG (no benchmarks) even though CG given as a clear justification for additively.

Introduces a concept of "annual IRR" - what is this?

Failure to monitor governance issues high.

Lessons do not receive adequate responses.

Corporate governance statements ill-founded and poorly thought-through. Then not followed-through.

Lack of clarity around expected IRRs - figures differ and keep changing for unclear reasons.

Learnings should be drawn out more clearly.

CG used as a justification for additiveness but then left unclear. Demoted to precaution when L Forbes had left.

Credit concern about pricing and valuation seemingly dismissed. Also Equally core concern about high value sector.

Environmental starts off strong but then wavers during reporting. Overly optimistic expectations of Ti.

Advice’s questions dismissed eg Board make-up.

Stoppy reporting be incomplete sentences and unhelpful statements eg "Mr Forbes... waiting for the improvement of value".

Lack of emphasis on ND has serious impact subsequently.

Additionality: Not mentioned in prospectus but subsequent reference to comfort from EBRD participation.

Was an risk-adjusted IRR of 7.% really acceptable?

CG judged as "sound" - how come?

What role was ND playing before L Forbes rescue?

Rushed - and resultant impact subsequently.

Lack of emphasis on ND has serious impact subsequently.

"political interference means unmitigated". Relevant one noted for a weak position.

Credit concern over the expected return which is seen as over-optimistic and also over extended length of holding - but unchanged in final document. Ti monitoring good although it is not clear why Ti analysis changes for the better with new risks being introduced.

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Nothing on CG (no benchmarks) even though CG given as a clear justification for additively.

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Was an risk-adjusted IRR of 7.% really acceptable?

CG judged as "sound" - how come?

What role was ND playing before L Forbes rescue?
<table>
<thead>
<tr>
<th></th>
<th>12</th>
<th>13</th>
<th>14</th>
<th>15</th>
<th>16</th>
<th>17</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Management changes</strong></td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td><strong>Value Creation drivers</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td><strong>Voluntary basis</strong></td>
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<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Risk-adjusted IRR</strong></td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td><strong>Range of target exit dates</strong></td>
<td>No</td>
<td>No</td>
<td>?</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td><strong>Factors influencing timing</strong></td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td><strong>Additionality</strong></td>
<td>Sound</td>
<td>Sound</td>
<td>Sound</td>
<td>Questionable</td>
<td>Questionable</td>
<td>Sound</td>
</tr>
<tr>
<td><strong>Compliance TI obj</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Governance Policy obj</strong></td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Governance structure</strong></td>
<td>No</td>
<td>Some</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td><strong>IFRS reporting existing</strong></td>
<td>Target</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Target</td>
<td>No</td>
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<tr>
<td><strong>Internal ND</strong></td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes (then no)</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Mi to Board considered</strong></td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td><strong>TA</strong></td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Global sponsor</strong></td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
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<td><strong>Political risk identified</strong></td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

**EXAMPLE**

Significant concerns expressed by Credit but went ahead.

Good risk analysis

Very little reference to CG even though problems start emerging through weak governance

Key learning around need for management due diligence not addressed.

Good emphasis on TI and governance - but then let down by weak benchmarks and subsequently by poor reporting. Very weak TI monitoring.

Risk analysis failed to consider the risks relating to Sponsor and project execution. Board also expressed concerns about Sponsor.

Good financial and strategic analysis

Little focus on key main risks

ND objectives set out and profile defined (to a degree).

Basic lack of understanding of how CG works in terms of boards and committees.

OCE comments on benchmarks weak.

Poor use of Learnings

Strong start not followed through with sound monitoring.

Legal and regulatory risks may not have received enough attention

Lack of focus on management issues despite these being key.

Evidence of importance of AC in governance leadership (G Rohan).

Management recognised as a key risk but assessment of management weak.

Value creation poorly addressed

A degree of moral hazard existed but was not identified or resolved.

IFRS target not followed through failure to disclose IFRS accounts.

Key lesson around not mixing debt and equity in projects sponsored by individuals was brushed off. As was need for strong, strategic industry sponsor.

Loss of focus on exit.

Was sound banking applied in assessing earlier performance?

Credit concerns over pricing not taken seriously despite full financial reporting picture is lost through absence of clear KPIs.

Emphasis on development of MI but then no focus on it in reporting.

Risks highlighted by Credit seemed to get little response.

No Audit Committee was established.
Annex 4: Structured approach to equity management

A more structured approach to monitoring financial value on both an individual and portfolio basis is evident compared to the 2009 position.

Establishment of the Equity Portfolio Management Unit and commissioning of the “Accounting Frameworks Limited” management system provides the data, analysis and expertise needed to support a more structured approach.

Equity Committee is now supported in its deliberations by a structured monitoring and reporting of basic equity data and an assessment of progress towards the achievement of financial objectives. Those involved in the process have commented this leads to more efficient and probing oversight from the Equity Committee.

Data and analysis provided to Equity Committee are now complemented by input from the Office of the Chief Economist and consultation with the Equity Portfolio Management Unit to provide a summary perspective on the stage of achievement of transition impact. Exit strategies are now being reviewed on a regular basis and changes to strategy being captured within the Equity Portfolio Management Unit. On this basis the Committee is in a better position to formulate recommendations to Operations Committee on whether to designate positions as ‘hold’ or make available for sale and on the appropriate exit strategy. It is a stated operating practice of the Equity Committee that investments which still have potential to achieve transition impact are not put forward for sale, whilst those that have achieved expected transition impact can be considered for sale. There is now more systematic liaison with Treasury on listed equity positions, including a bi weekly review of positions, market and exit opportunities (including the possibility of small scale drip-feeding to the market, which was considered sensitive and not very applicable to the EBRD at the time of the 2009 EvD study).

The structure of Equity Committee has also been adjusted to provide a broader view of the portfolio. The Committee is now chaired by the First Vice President, Banking (previously chaired by the Business Group Director, which was one of the line positions) and a committee position has been made available for the Managing Director, Portfolio, Banking. These changes have helped overcome some of the issues identified in our previous report.

Equity Committee engagement is now complemented by periodic value creation meetings led by the First Vice President Banking (or increasingly with the Managing Director Portfolio Business Group), supported by the Equity Portfolio Management Unit. The focus of these meetings is the actions required to achieve project objectives and increase in value.

Continuing Equity Portfolio Management Unit work is in hand to refine analysis, support better understanding of valuation models across teams, establish better linkage with Treasury to incorporate more external data and support a continuous push to ensure consistency of approach.

Equity reporting to the Board has also improved, as reflected in the Quarterly Risk Report. The Equity Portfolio section now provides a summary, based on the fair valuations, including trends in the portfolio (also considered against market movements), main movers/under-performers, diversification and the current internal rate of return position assessed by sector and overall. Information on exited investments is also provided. This is an effective short summary to provide the Board with a regular update on the equity investment portfolio.
Annex 5: Summary of corporate governance transition impact benchmarks

<table>
<thead>
<tr>
<th>Investment</th>
<th>Corporate governance transition impact objective</th>
<th>Corporate governance monitoring benchmarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Client AG</td>
<td>Corporate Governance and Business Standards</td>
<td>Successful introductions and implementation of management information system across the consolidated group</td>
</tr>
</tbody>
</table>
| Client CP  | Setting standards for corporate governance, environmental and business conduct | – Publication on the Company web site of the payments made to the Ukrainian authorities in relation to extractive operations (PWYP) in both Ukrainian and English  
– Publication of the 2006 audited financials on the company website  
– Allocation of a board seat to the Bank  
– Appointment of a non-executive independent chairman of the board in consultation with the Bank  
– Compliance with the OECD ‘Principles of Corporate Governance’  
– Adoption and compliance of a code of conduct defined in accordance with the Bank  
– Establishment of a board committee for corporate governance chaired by the Bank’s representative  
– Establishment of a board committee for remuneration chaired by an independent director  
– Simplification of corporate structure in line with Deloitte’s recommendations |
| Client E   | Promoting private ownership and management        | Ensure proper representation of minority shareholders in the Supervisory Board Meeting, that is, an independent board member |
| Client EC  | Setting standards for corporate governance and business conduct | Appointment of an external sector specialist to the supervisory board |
| Client GP  | Corporate governance/ access to capital markets   | None |
| Client G   | Corporate governance/ access to capital markets   | – Appointment of an independent director  
– Adoption of a policy on protection of rights of minority shareholders  
– Compliance with the corporate governance code, including the policy on protection of minority shareholders  
– Increase in the free float of Client G shares to 45-50 per cent |
| Client L   | Improvement of corporate governance and business standards | – Appoint an independent non-executive director for the company’s supervisory board  
– Appoint an EBRD representative on Client L’s audit committee |
| Client MW  | None                                             | None |
| Client M   | None                                             | None |
| Client MM  | None                                             | None |
| Client O   | None                                             | None |
| Client PI  | Setting standards for corporate governance        | – IFRS audited statements for all trustee companies  
– Streamlining the business organisation (along profit and support centres)  
– Setting appropriate corporate structure including supervisory board with independent director(s) |
| Client | Setting standards for corporate governance and demonstration of new replicable behaviour at a corporate level | – Ensure transparent ownership structure  
– Introduction of IFRS accounting  
– Enhance independence and competencies of supervisory board:  
  o One additional independent member  
  o Second independent member  
  o Implement audit committee and remuneration committee |
| Client RG |  |  |
| Client SC | Standard for business conduct | Introduction of audited IFRS accounting |
| Client T | Setting standards for business conduct | None |
| Client T2 | Setting standards for business conduct | – The EBRD to obtain the right to nominate an independent director  
– Adoption by the company of policy documents on corporate governance  
– Maintain audit and remuneration committee of the board |
| Client VG | Improvement of corporate governance | – Creation of a supervisory board  
– EBRD supervisory board seat |
Annex 6: Corporate governance findings

The role of the (supervisory) board

Even within the limited scope of the board, assessment is poor. For example, in nearly all cases the assessment of the board is limited to the provision of biographies with no attempt made to assess profiles against what is needed for effective governance. There is barely any reference to the mix and quality of board membership: this is a primary influence on the quality of the board and governance; it is an issue which greatly exercises chairmen of UK plc’s and value creation investors but receives no attention. Furthermore, there is no evaluation of how the make-up of the board might allow it to exercise influence in the face of a dominant chairman, owner or chief executive officer. This will be key for the effectiveness of the Bank’s nominee director in securing transition impact but it receives little or no attention.

Assessing how the board operates is difficult but an analyst with a reasonable understanding of the factors influencing effective board and governance operation should be able to glean an impression from discussions with management and possibly the current directors.

There are no references to the quality of information or papers submitted to the board of directors: the quality of these is a key factor in determining whether effective governance can be established. It is relatively easy to form a view on this if the analyst has an idea of what to look for so, if access to some recent Board papers can be secured, it should be possible to form a view.

Other internal aspects of the governance framework

Going beyond governance within the boardroom, assessment is sparse. For example:

- Attempts to present a view of the extent of internal controls or risk management are virtually absent. The Bank will not be in a position to assess this itself but certain indicators will be available: for example, in not one case is there a statement on the existence of an internal audit function, let alone on its size, role or (possibly) its effectiveness. Alternatively it might be in a position to obtain copies of the auditors’ management letter (of both international standard and local standard auditors).

  The lack of consideration of internal audit is striking: in the 2009 evaluation study, internal audit development received a lot of attention. In the EBRD region internal audit practices have developed in some cases but are, in general, far from being at international standards. Internal audit is a crucial element of developing sound governance and its development is a practical, definable development which could be sought by the Bank but it receives hardly any attention.

- On both these points there is scope for including them in a description of the developments that the nominee director should be assessing and, most likely, pushing.

- The assessment of the audit approach can be extended to consider how far other forms of external or internal assurance are engaged or developed, for example, health and safety audit; environmental audit and ISO audits.

- In only a handful of cases (for example Client AG and Client VG) is there reference to the need to strengthen management information systems. This is very different from the cases considered in the previous review where considerable importance was attached to the development of management information: it is difficult to believe that approaches to
management information have improved to an extent that it is no longer an important factor. Management information development will be key to value creation yet it receives very little attention.

- There is no consideration of specifics around policy structures which may give an indication of the governance approach or quality, for example insider dealing policies (where relevant); related party transaction rules; delegation of authority limits and guidance; the nature of the reserved matters; the existence and terms of reference of management committees (such as the credit committee, anti-money laundering committee and investment project management committee).

**Governance policies and structures**

In only two cases is the implementation of a governance policy specified as an objective, and then the references are vague. The setting out of a governance policy or framework is an important step in getting an organisation to think through what it wants its governance to achieve and what it might look like. It also provides a basis for the formal involvement of the board in agreeing the approach. The apparent lack of a push for formalised frameworks is a missed opportunity.

In no case is the question of the content of such a policy considered although in one cases there is a fleeting reference to it being “in line with the EBRD standard policy” and in the other a weak document produced by a law firm is provided although it is unclear how, if at all, it was used in practice.

The actual application of the policy not assessed subsequently; there is usually a reference to its formal adoption as part of the benchmarking but no references to the resulting changes in practice. The formal adoption of a governance policy does not equate automatically to where it is followed in practice: so whether or not a governance impact has been achieved remains unclear.

The governance goals of the organisation are not defined and the question of how strengthened governance may support improved performance of preservation of value is not addressed.

The governance structures are not always described; this happens in only one and even there the roles to be played by different parts of the structure are not set out.

**Transparency**

The sample gave little indication of a push to require greater transparency. In part this might reflect an existing trend towards IFRS reporting amongst investee companies. How far this is the case is unclear from the final review memoranda: only four of these clearly stated that the company was already reporting on an IFRS basis before investment; in the others there is no explanation as to the basis of the accounting information (except one where it states reporting only on the basis of local GAAP). Furthermore, in those companies where it was unclear, there was no emphasis on requiring a shift to IFRS accounting. This contrasts with the emphasis seen during the last review. In certain cases, even where there was a focus on IFRS reporting, this focus was not maintained when there was a delay in producing IFRS accounts; or simply it was unclear what happened.

**Examples:**

- Client T2: a commitment was made to annual IFRS reporting but they then ceased to publish IFRS accounts (although this was subsequently addressed).
Client RG: Monitoring failed to refer back to the 2006 IFRS accounts when they did become available even though their non-availability had been a concern on entry and it had not been possible to use them in pricing.

In addition to the IFRS question, there is no consideration in any of the investments of how companies report externally either in a structured form (such as the quality of an annual report, the use of corporate social responsibility reports or “business review” style reporting) or through their websites (including the publication of presentations to analysts or bond holders where appropriate). While unlisted companies may not feel the need to publish this type of information, where they do it should be noted and assessed as a useful indicator of governance attitudes. Where they do not, it could be identified as a possible governance target: when companies start making public statements on performance or targets, it can change behaviour.

Examples:

Client AG: the assessment of corporate governance is weak [expand] with no corporate governance-related benchmarks.

Client CP: governance objectives are well-defined but the monitoring assessments are out of line with commentary of governance problems outlined elsewhere in the report.

Client E: a heavy emphasis is placed on the supervisory board and a request is made for the establishment of an audit committee and a remuneration committee but this fails to take into account the political context which will make the operation of these structures difficult. The governance intent is evident at the outset but is then not followed through in monitoring.

Client GP: a weak approach to assessing governance is reflected in a continuing lack of understanding as issues start emerging (and when there is a reference to “daily conference calls” involving the board there is no explanation despite the implied seriousness of the situation).

Client G: references to “complying with the Code” are confused and imply a lack of understanding of UK listing rules and governance standards. Advisor’s questions on the board make-up were summarily dismissed. Delays in taking steps to implement governance policies appear to go unchallenged. Corporate governance was used as a strong justification for additionality but was then seemingly demoted as problems arose in appointing a nominee director due to a lack of due diligence in assessing governance regulation. Achieving governance goals subsequently received little monitoring coverage.

Client MW: there was no reference to the foreign parent’s governance policies which surely must have been relevant. Corporate governance statements appeared to be ill-thought out then not followed through.

Client O: governance is described as a “key theme” but there is no expansion on this and no evident understanding of governance issues.

Client SC: there is very little reference to governance but problems then start emerging through weak governance.

Client T2: a valiant attempt is made to set out the board and committee membership and structures, implying a commitment to assess and address governance – but it is fully undermined by a failure to appreciate the difference between executive committees (which
these were) and governance oversight committees of the Board; also the highly political make-up of the board is not properly considered. The weaknesses in this analysis result in a failure to identify governance issues which become a problem until a new nominee director is appointed to the board and sorts out the audit committee.

- Client VG: there was a good emphasis on governance at the outset but this was then let down by poor reporting.
### Annex 7: Operation leader survey on nominee director reporting

<table>
<thead>
<tr>
<th>ISSUE</th>
<th>INCLUDED IN ND REPORTS Y/N</th>
<th>QUALITY OF REPORTING 1-5</th>
<th>ND Reports</th>
<th>ISSUE</th>
<th>INCLUDED IN ND REPORTS Y/N</th>
<th>APPROV AVG DURATION</th>
<th>OTHER</th>
<th>DO NOT GET THIS INFO</th>
<th>FREE FORMAT COMMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>The quality/role/standing of internal audit</td>
<td>Y</td>
<td>5</td>
<td></td>
<td>The quality/role/standing of internal audit</td>
<td>Y</td>
<td>3h</td>
<td></td>
<td></td>
<td>The quality/role/standing of internal audit. There is an internal audit committee, which reports to SB on their findings 2-3 times a year.</td>
</tr>
<tr>
<td>The work of the audit committee</td>
<td>Y</td>
<td>5</td>
<td></td>
<td>The work of the audit committee</td>
<td>Y</td>
<td></td>
<td></td>
<td></td>
<td>The work of the audit committee is of good quality especially in terms of one off adjustments on EBITDA.</td>
</tr>
<tr>
<td>The quality and reliability/openness of management reporting to the Board</td>
<td>Y</td>
<td>5</td>
<td></td>
<td>The quality and reliability/openness of management reporting to the Board</td>
<td>Y</td>
<td></td>
<td></td>
<td></td>
<td>The quality and reliability of information supplied by management is high. Also the management follows up on each demand of SB members promptly.</td>
</tr>
<tr>
<td>The level of development of KPIs</td>
<td>Y</td>
<td>5</td>
<td></td>
<td>The level of development of KPIs</td>
<td>Y</td>
<td></td>
<td></td>
<td></td>
<td>The ND challenges the management on KPIs, and suggests potential improvements on each of SB meetings.</td>
</tr>
<tr>
<td>The timing of Board debate/decision-making in relation to proposal and decision (i.e. are decisions really subject to Board discussion as opposed to rubber stamping)</td>
<td>Y</td>
<td>5</td>
<td></td>
<td>The timing of Board debate/decision-making in relation to proposal and decision (i.e. are decisions really subject to Board discussion as opposed to rubber stamping)</td>
<td>Y</td>
<td></td>
<td></td>
<td></td>
<td>All the proposals and decisions are actively discussed on each SB meeting. There is also a follow up on each of discussed matters on next SB.</td>
</tr>
<tr>
<td>The level of development/progress in development of internal control and risk management</td>
<td>Y</td>
<td>5</td>
<td></td>
<td>The level of development/progress in development of internal control and risk management</td>
<td>Y</td>
<td></td>
<td></td>
<td></td>
<td>The company has developed internal control and risk management departments, which are regularly being improved. Recently the company formed hedging and procurement committees.</td>
</tr>
<tr>
<td>Is length of board and committee meetings included in ND report. Indicate average duration.</td>
<td>Y</td>
<td>3h</td>
<td></td>
<td>Is length of board and committee meetings included in ND report. Indicate average duration.</td>
<td>Y</td>
<td></td>
<td></td>
<td></td>
<td>The normal SB meeting can take from 2-4h, and are occasionally accompanied by production site visits.</td>
</tr>
</tbody>
</table>

SB= Supervisory board  
ND= Nominee director  
KPI= key performance indicators  
EBITDA= earnings before interest, tax, depreciation and amortization