Equity investment in a commercial bank
Summary of the Operation Performance Evaluation Review (OPER)
April 2003

Project description
In 1999 the EBRD acquired, through a secondary public offer arranged on behalf of the State Fund, share capital in a bank. The offer represented the final stage of privatisation of this bank. The joint lead managers (“the arrangers”) were also the joint global coordinators and bookrunners. The offer was not formally underwritten. The arrangers undertook a standard book-building process in dialogue with potential investors, including the EBRD.

Project rationale and achievement of objectives
At appraisal it was anticipated that the investment would give the EBRD the opportunity to support the bank’s final stage of privatisation and provide a first-class low-risk asset with good liquidity, consistent with the EBRD’s investment portfolio. The shares were expected to provide steady capital growth and a consistent dividend income. The proposed investment strategy was to hold the share for a period of time — subject to it meeting the Bank’s profit and IRR expectations — and to exit via the local stock exchange, where this was one of the most liquid stocks. While the specific objectives of the project were not clearly defined, the authorities did state that the EBRD’s participation lent support to the bank’s privatisation. In addition, the EBRD received dividends amounting in aggregate to over 6 per cent of the price paid. As at end January 2003, the investment had an unrealised capital gain of approximately 240 per cent. The overall achievement of objectives has been rated Good.

OVERALL ASSESSMENT
PED has assigned a rating of Partly Successful to this project. To date, the financial performance of the investment has been excellent with an average dividend annually of over 2 per cent of the price paid. There is also substantial unrealised capital gain. While the investment performance of the operation is high, it has performed less well when reviewed against the Bank’s mandated benchmarks for transition impact and additionality.

Transition impact and the Bank’s additionality
The OPER Team has assigned a transition impact rating of Marginal to the project. The acquisition of a 2 per cent stake has contributed little to the transition process: the enterprise was already building a financial services group around a universal bank dominating its home market, prior to the EBRD’s investment. As regards governance, the EBRD neither had, nor gained, any position of formal influence greater than any other large institutional investor. In addition, the Bank did not obtain an adequate reward for enhancing the financial value of the shares by taking part in the secondary public offer. Through a ‘special share’, the state has retained a power of veto over a number of decisions that would otherwise have been the prerogative of the Management and Supervisory Boards. While it appears that to date the state has been satisfied with a passive role, the potential for interference remains.

Additionality is Verified in Part. The EBRD’s prestige as an anchor investor was said by participants to have helped the success of the offer. It is not possible, however, to measure the impact of the Bank’s role objectively because of the inherent lack of transparency in the book-building process. Moreover, all participants and observers interviewed by the OPER Team commented that the offer would have succeeded without the EBRD’s involvement. In a country less advanced in the transition process, as in this case, the Bank’s participation in a secondary offer may have brought with it some skills transfer to the local parties. However, as the client and the Privatisation Agency had previous experience in similar transactions, the Bank cannot be said to have brought additional expertise.
Bank handling
While satisfying the financial returns criterion, this equity investment appears to have been undertaken with no real prospect for contributing to transition. Since the promotion of transition impact is a fundamental principle of the Strategic Portfolio Management Approach, as it is for all EBRD investments, the OPER Team considers that this equity investment did not comply with the Bank’s transition mandate and should not have been developed. The transition impact potential of the client’s ambitions to expand within the region is substantial. However, the EBRD has no formal influence to contribute to policy dialogue or to pursue environmental improvements, nor can the Bank ensure that the increased risks associated with expansion are properly assessed and mitigated. For these reasons, the OPER Team has assigned a rating of Marginal for bank handling.

LESSONS LEARNED

Appropriate fees should be negotiated and collected when the EBRD provides special services. This project involved a typical underwriting situation, with a risk being taken based on a long-term view of the market. When the EBRD provides services which enhance the financial gain of other participants, it is appropriate for the Bank to seek a fair reward. In certain circumstances the Bank may choose to measure such a reward in terms of transition impact or enhancement of environmental performance and change. However, where the services contribute directly to the financial gain of other participants, the Bank should charge suitably for these services, in accordance with sound business practice.

The Bank should lead policy dialogue at the government level to remove opportunities for the state to interfere in the operation of the market. The issue of a single special share with extraordinary rights to the state may threaten the free operation of the company concerned and the market. In fact, the sale by the state in this case of its remaining minority holding of ordinary shares achieved less, in terms of completing the privatisation process, than relinquishing the special share rights would have achieved.

Market fluctuations should not be assumed to indicate market malfunction. It may be appropriate for the Bank to help build or restore investor confidence in an underdeveloped local market or a market which has suffered a severe shock. Such activity may comply with the Bank’s transition mandate if it contributes to the proper functioning of the market. This is unlikely to be the case when the market has experienced price fluctuations, but otherwise has been functioning normally. Nor is it likely to apply where the target institution has already had experience of public offerings and already has a significant foreign presence among its institutional investors.

All projects, including portfolio investments, must have transition impact and additionality. Projects considered under the strategic approach to portfolio management, and offering a high return, must still comply with the Bank’s mandate requirements. For projects with a transition impact rating at appraisal of not more than satisfactory, additionality should be carefully substantiated at the appraisal stage. Transition impact potential should also be considered when deciding the timing of disposal.

The Bank should not assume that the environmental conditions attached to loan agreements can be applied to equity investments. The Bank should recognise that it cannot apply environmental safeguard controls to equity stakes acquired in the open market. In the present case, for example, repayment of the loan would remove the Bank’s levers of influence on environmental matters. In the absence of such levers, the Bank should be prepared to consider selling its stake if it is not possible to uphold environmental conditionalities.