Pre-privatisation equity investment in a commercial bank

Summary of the Operation Performance Evaluation Review (March 2004)

Project description

In November 2000 the EBRD's Board approved the purchase of up to 20 per cent of the issued share capital of a bank preparing for privatisation. The approved project included the proposed initial investment, a commitment to increase – in defined circumstances – the amount paid (an adjustment payment), and a balance to allow for any further capital increases. The exit strategy anticipated the sale of the EBRD's shares to a strategic investor, or alternatively sale of the shares on the stock exchange. To protect the EBRD from the delay or failure of the privatisation process, a "put" option was negotiated. This could be exercised if the privatisation was not completed by a specified target date.

When the project was signed in February 2001, the EBRD and another financial investor each took a 12.5 per cent stake in the bank's share capital. A strategic investor was selected by the government in July 2001. The contractual arrangements with the government also included a "call" option which the government could exercise if the strategic investor wanted to take full control of the bank. The strategic investor did decide to take this course and the government called the EBRD shares. The Bank exited the investment in September 2001.

Project rationale

When the project was conceived, a significant proportion of banking sector assets remained under state control. Banks were burdened with the legacy of directed lending and poor management. As a result, privatisation and reform of the sector was slow to commence.

As well as supporting the privatisation of a major bank, the project enabled the EBRD to contribute to the restructuring of the bank and the improvement of governance. Although the strategic investor subsequently decided to proceed without involving the EBRD in these areas, the underlying rationale – to move privatisation of the bank swiftly forward – was fully consistent with the EBRD mandate.

Achievement of objectives

The project had a two-fold objective: to facilitate the restructuring of the client's operations, followed by the sale of the remaining government stake to a strategic investor. There was a clear exit strategy that envisaged an eventual sale on the local stock exchange, if a strategic investor could not be found. The EBRD was further protected by the "put" option to the government, which could be invoked if full privatisation did not take place within 12 months, or if the strategic investor was not acceptable to the Bank. The objective of attracting a sound strategic investor with the willingness and capacity to take the privatised bank forward was accomplished within a very short timescale. The overall achievement of objectives was rated *Good*.

Overall assessment

The OPER Team has assigned this project a rating of *Successful.* The project progressed with unexpected speed, to the extent that a strategic investor was identified and took over the running of the target shortly after the EBRD and *the other financial investor* acquired their pre-privatisation stakes. The overall transition impact has been assessed as *Good*. The initial project design envisaged a period during which the Bank would work to restructure the target, thus enhancing its appeal to an investor. The OPER Team's enquiries suggest that the Bank's efforts had an immediate impact on strategic thinking. Success was also achieved in restructuring the balance sheet. However, the short timeframe of the EBRD's involvement allowed for only limited changes to be made to senior and middle management. The strategic investor considered it necessary to begin making unusually sweeping changes to first and second tier management appointments shortly after taking control. The project represented significant progress in the privatisation of major institutions in the financial sector, after several years of delay.

Transition impact and Bank's additionality

The OPER Team assigned a transition impact rating of *Good* to the project. The operation achieved considerable impact in a short timeframe, facilitated by the manner in which it was structured. At approval stage, the project's transition impact potential was expected to be derived from its support for the restructuring and privatisation of the client. By promoting restructuring in the run-up to privatisation, the project was expected to increase confidence in the client, the banking sector and among potential investors. These transition expectations were realised.

The project played an important role in the final stage of privatisation. Based on discussions with various participants, the OPER Team concluded that the EBRD participation in the governance of the client, particularly the presence on the Supervisory Board, immediately had a positive effect. It prepared the ground for change. The EBRD encouraged the client's Board to begin operating like a commercial entity, rather than a state bank, giving proper consideration to lending policy and the risk/return profile. In addition, work commenced on restructuring the balance sheet and planning management change.

With the arrival of the strategic investor, these changes gathered pace. The strategic investor took over from the EBRD in restructuring the bank. The project was pivotal in encouraging the restructure of the country's banking sector, which had been much-delayed. The EBRD additionality was especially significant in the design and structure of the operation, in particular securing the government's commitment to completing the privatisation process.

Bank handling

The Bank carried out extensive due diligence, which included a detailed examination of the client's treasury policy and procedures and extensive reviews of the credit portfolio and financial information. The project required complex structuring as several counterparts were involved and each had different approaches to the investment. Some flexibility and sensitivity to the different business cultures was also required, both in the structure and implementation of the project. On the one hand, the client's management and the government, which were both committed to the privatisation, wanted the early focus to be on the restructuring of the state-owned and controlled bank. At the same time, the leading investment bank, which had been appointed to advise the government on the privatisation, approached the pricing negotiations aggressively. Meanwhile, the IFIs were concerned with the contribution of the operation to the transition process. The OPER Team believes the operation team handled the potentially conflicting approaches astutely for the ultimate benefit of the client. Complex documentation was required to cover the extensive range of potential outcomes. Bank handling was rated *Good*.

Lessons learned

An appropriately structured "put" mechanism may serve to confirm official commitment to privatisation. Pre-privatisation equity can increase confidence and help ensure a successful privatisation. In certain circumstances, the potential for success can be enhanced by using a "put" mechanism to reinforce official commitment to completing the privatisation process.

Acceptance by the EBRD of a client-led strategy may accelerate achievement of a privatisation objective. Provided the details of the strategy are consistent with the Bank's mandate and operational standards, it may be appropriate for the EBRD to agree to a transaction structure put forward by a client. Flexibility by the Bank in this regard may strengthen the client's commitment to privatisation. However, the Bank may have to accept a lower potential financial return if aspects of the structure proposed by the client weaken opportunities for the Bank to maximise its share of future returns.

Co-investment with partners who have less appetite for risk may necessitate acceptance of a lower potential return by the EBRD. As a general rule, basing the Bank's offer price on a realistic valuation contributes to the transition process by encouraging the target to think in terms of its net asset value, calculated in accordance with sound commercial principles. If, however, a co-investor with the Bank is less willing to accept a given level of risk, it may be appropriate for the Bank to accept a correspondingly lower potential return to achieve the project's overall objectives.

Complexities in "put" and "call" arrangements should be avoided if possible. In the case featured, the mechanism was designed to protect the participants' differing approaches and goals. While the complex formulation of this mechanism may have been necessary for the project to proceed, these complexities may have contributed to the strategic investor deciding to "call" the Bank's shares.