Special Study

Regional Venture Funds Programme

Russian Federation

(A private sector investment operation)

May 2006

Evaluation Department
(EvD)

European Bank
for Reconstruction and Development

SPECIAL STUDY

PREFACE

The subject of this special study is the Regional Venture Funds Programme in Russia, a private sector investment operation, which involved the commitment of approximately US$ 312 million to 11 new private equity funds. The report has been executed by William Keenan, Senior Evaluation Manager.

Information on the operation was obtained from relevant teams and departments of the Bank and its files as well as from external sector and industry sources. The operation team and other relevant Bank staff commented on an early draft of this report. Fieldwork was carried out in June 2005. The Evaluation Department (EvD) would like to take this opportunity to thank those who contributed to the production of this report.

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ABBREVIATIONS

EBRD	European Bank for Reconstruction and Development
EVCA	European Venture Capital Association
EvD	Evaluation Department
FI	Financial Institutions
IFI	International Finance Institution
IRR	Internal Rate of Return
MTR	Mid-term review
RVCA	Russian Venture Capital Association
RVFs	Regional Venture Funds
TC	Technical cooperation
TI	Transition impact
US$	United States dollar

DEFINED TERMS

the Bank, EBRD	the European Bank for Reconstruction and Development.
the Evaluation Team	Staff of the Evaluation Department who jointly carried out the post-evaluation
the Operation Team	the staff in the Banking Department and other respective departments within the Bank responsible for the operation appraisal, negotiation and monitoring.

1. THE PROJECT

1.1 The Regional Venture Funds programme

Between 1993 and 1996 the Board approved the establishment of 11 Regional Venture Funds (RVFs) in Russia which were set up between 1994 and 1997 with total committed capital of approximately US$ 312 million.[1] The initiative which led to the programme was taken in 1993 by the G7 together with the Russian government. The primary objective was to create the infrastructure for making private equity investments in medium-sized private companies in the Russian regions with the ultimate aim of attracting further capital from private investors to demonstrate the viability of private equity in Russia. Experienced private equity managers were sought to run each of the RVFs. However, there were few if any fund managers with experience of early stage equity in Russia and one of the first, and most demanding tasks was to introduce the concept to potential investee companies. Considerable operational difficulties were faced initially and, while some of the selected fund managers demonstrated commitment from the outset, others appeared to be less committed. To begin with, therefore, there was slow progress in making investments such that less than US$ 50 million was invested between 1994 and 1997.

The Bank began an extensive review of the arrangements in 1998 in order to identify the best-performing fund managers. As a result, the management of the RVFs was restructured, some managers were dismissed and some funds were brought together under managers whose performance held out stronger promise of creating funds with critical mass. The restructuring took place in the immediate aftermath of the August 1998 financial crisis and there was something of a hiatus in performance in 1998 and 1999. Following the investment of around US$ 50 million by the funds in those two years, the recovery in Russia led to increased investment of around US$ 100 million in 2000 and 2001.

Post-crisis prospects improved with the devaluation of the rouble and the improvement that resulted in prospects for investments relating, for example, to import substitution in industries such as food processing. Figures compiled by the Financial Institutions (FI) team show a total investment cost by the end of 2004 of US$ 238 million in 93 investee companies from 11 funds run by 7 fund managers.[2] The total investment value of the funds at the end of 2004 comprised dividend receipts and exit proceeds together with the carrying value of the remaining portfolio and amounted to approximately US$ 347 million. This implies an investment profit of around US$ 109 million over the life of the funds to December 2004 before TC costs of approximately US$ 118 million and direct EBRD costs of around US$ 6 million.

By the end of 2004, with the exception of the North-west and west Russia II fund – a follow-on fund approved by the EBRD in 2003 – the funds were by and large fully invested and in the exit phase. However, only 39 of the 93 investments had been fully exited. The carrying value of the remaining portfolio was calculated on a prudent and relatively conservative basis and did not fully reflect anticipated investment profits. There were some highly profitable exits during 2005 such that total cash proceeds (cash from dividends and exits) rose from an accumulated US$ 179 million by the end of 2004 to US$ 268 million by the close of 2005. In terms of overall financial performance, therefore, the picture of somewhat disappointing returns altered during 2005 to a more promising demonstration of the returns possible from equity investments in medium-sized companies in an expanding economy.

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[1] The 'fund currency' in ten cases was US dollars. The 'fund currency' in one case was euros. The currency of denominating TC funds depended on the identity of the donor. In the present report, except where clearly stated, monetary values are presented in US dollars to permit comparison and aggregation of data on a consistent basis.

[2] Confirmed data on fund performance are available to the end of 2004. Preliminary data are available for 2005, but are subject to audit adjustments.

1.2 The funds and the fund managers

This evaluation assesses the performance of funds as grouped under their respective managers following the restructuring which began in 1998 around the best-performing fund managers. For the purposes of the evaluation, therefore, the funds are grouped as shown in the following table:

Russian Regional Venture Funds at 31 December 2004

REGIONS AND DONORS	TOTAL EBRD CAPITAL COMMITTED US$ MILLION	TOTAL INVESTMENT COST US$ MILLION
Urals, Black Earth, Smolensk EU	72	58.6
North-west and west Russia Finland, Norway and Sweden	60	56.6
Central Russia, St Petersburg Germany	60	53.3
Lower Volga United States	30	29.5
West Siberia EU	30	20.2
Far East and eastern Siberia Japan	30	13.2
Southern Russia France	30	6.5
Total	**312**	**237.9**

The funds are organised as managed funds of the Bank, as a result of which each individual investment by an RVF is held on the Bank's balance sheet. The funds were set up with a 10-year life cycle initially. The restructuring and the 1998 crisis contributed to delays in identifying investment targets. Extensions have been granted where considered necessary to permit funds to complete the divestment from their portfolios.

1.3 TC support

The RVF concept could not have been realised without substantial donor-funded TC support. At the design stage it was expected that donor governments would commit TC funds in the ratio of 40 per cent donor funding to 60 per cent EBRD capital. This would be used to pay the expenses of fund managers and the costs of due diligence on proposed investee companies and post-investment support. The largest donor was the EU, followed by Germany, the United States, Japan, the Nordic countries, Italy and France.[3] The 40/60 ratio was adopted when the

[3] The donors and the regions they supported are shown in the table in 1.2 above. The Italian government supported the west Russia RVF until its merger with the North-west Russia RVF.

programme was being designed and it is important to note that at the time, in the early 1990s, no experience was available on which to estimate with any accuracy the volume of technical assistance which would be required. It was envisaged that about one-half of the TC funds would be used to pay management fees over the lives of the funds, while the remainder would be used to cover the cost of pre-investment due diligence and post-investment consulting support. For various reasons, individual donors reviewed their level of support for the RVFs, resulting in revised commitments which were overall substantially less than planned at the outset.

Compared with donor funding of around US$ 208 million expected initially, approximately US$ 121 million equivalent was disbursed by the end of 2004, of which around US$ 84 million (70 per cent) was in respect of fund managers' fees. TC performance is assessed in section 6 below.

1.4 Mid-term review by EvD in 1997

The Evaluation Department (EvD) conducted a mid-term review (MTR) in 1997 of the RVF programme based on a sample of RVF operations. As noted above, initial progress had been slow and the review was undertaken at the request of Bank management and some donors to assess the programme's design, implementation and prospects for success. By mid-June 1997 only 22 investments had been signed for a total value of US$ 33 million or 11 per cent of the capital then committed. It was noted that in a pioneering environment such as the regions of Russia, where there was no precedent for the programme, a considerable gestation time was necessary before results could reasonably be expected.

Among key recommendations, the MTR proposed that the capital bases of the funds were too small to attract the desired calibre of fund manager in many cases and that the number of fund managers should be rationalised. The MTR also proposed a review of the programme's investment policy which had become overly restrictive in the light of the rapid commercial developments that had taken place in Russia since the programme was conceived.[4] Moreover, the approach of using fly-in senior managers and specialists to supplement a small number of local staff had not proved effective. Some fund managers needed to demonstrate greater commitment to working in the regions.

In retrospect it can be noted that the MTR and the implementation of key recommendations were very timely indeed since it is clear that some of the stronger funds which resulted from the process were better able to recover from the shock of the August 1998 financial crisis.

1.5 Scope of the special study

The present evaluation takes place during or close to the exit phase of the funds under review. The study therefore focuses on the investment performance of the funds in order to assess their transition impact in this light, and to draw lessons for future private equity operations by the Bank in Russia and elsewhere. The effectiveness of TC support is also assessed. The evaluation team visited two of the leading fund managers in Russia in mid-2005. When the RVFs were being set up, a similarly structured fund was established in Kazakhstan. However, the performance of the Kazakh fund is not considered in this study. Wider reviews of the Bank's equity funds outside Europe and of the post-privatisation funds, as well as a review of the Bank's Financial Sector Policy, will be conducted by EvD during 2006.

[4] The Board approved a revised Investment Policy for the RVFs in July 1998. Appendix 5 to this special study contains a summary of RVF investment objectives.

1.6 Successor funds

Since late 2002 the EBRD's Board of directors has approved the Bank's participation in four successor funds. In each case the Bank's commitment is subject to the raising of private capital from third parties. The existence of these new funds, their operation without additional TC support, and the attraction of private capital alongside that of the Bank and other International Financial Institutions (IFIs) are indicators of the growing demonstration effect of those funds which have achieved financial success.

2. PROGRAMME RATIONALE

The Bank and donors recognised that there was a severe shortage of capital to support private investment in the Russian regions. Private equity funds were seen as an important potential source of new capital for medium-sized companies. The rationale for the RVF programme was to develop a cluster of experienced private equity managers who would establish a track record of making investments in medium-sized private companies and in due course attract private finance. As noted above, the programme was strongly supported by the donor community.

3. ACHIEVEMENT OF OBJECTIVES

The Bank had twin objectives for the RVF programme. The first was to provide new equity capital to medium-sized enterprises on commercial terms. A reliable proxy for measuring the achievement of this objective is the financial performance of the funds individually and overall. All of the funds under review are in the exit phase. In some cases the life of the fund has been extended to allow the remaining portfolio to be exited. Where a fund has achieved a positive return on capital as reflected in particular in the realised divestments, it appears reasonable to conclude that the investments were made on commercial terms. A target Internal Rate of Return (IRR) range of 20-25 per cent was set for the funds at appraisal. However, the very difficult environment that prevailed, in particular in the early years of the funds, made the targets virtually unattainable. Nevertheless, a number of successful exits recorded in 2005 have boosted financial performance. Estimated gross IRRs ranging from a high of 13 per cent to a low of 0 per cent have been achieved as at 31 December 2005. Estimated net IRRs, taking account of EBRD costs but not TC funds consumed, range from 10 per cent to -4 per cent. The average estimated gross IRR over all funds is 8 per cent (net IRR 5 per cent). On the basis of these results, the evaluation team concludes that overall the objective of providing new equity capital to medium-sized enterprises on commercial terms has been achieved.

The second RVF objective was to create a sustainable infrastructure for making private equity investments in the Russian regions. To achieve this, the RVFs were initially set up on the basis of a 40 per cent to 60 per cent donor funding to capital ratio.[5] The funds consumed fewer TC funds than originally planned, as explained in the assessment of TC performance in section 6 below. Through December 2005 the RVFs consumed approximately US$ 121 million of TC monies. An appropriate measure of whether the objective of creating a sustainable infrastructure is being achieved would be confirmation of the establishment of follow-on, or successor funds to those that were founded with EBRD capital. It is apparent that the various funds have not

[5] TC monies have not been allocated to follow-on funds.

performed evenly. Account must be taken of the challenging operating environment and of the fact that the RVFs were the first of their kind to be established in Russia. It took several years for a number of investee companies to recover from the 1998 shock. Moreover, in the reorganisation of the funds, some managers who were retained agreed to take over an existing portfolio of investment 'dogs' which required careful and time-consuming workout and inevitably detracted from the funds' overall performance. The evaluation team considers that it is appropriate to look beyond the financial performance of the funds for evidence of increasing investor interest in Russia.

One clear indicator of the RVF's contribution to the creation of a sustainable infrastructure for investment is the establishment of the Russian Venture Capital Association which the EBRD was instrumental in founding, and of which a number of the funds are founder-members. As demonstrated by the RVCA membership, serious interest in private equity opportunities in Russia continues to grow.[6] A further contribution to creating a sustainable infrastructure has been the skills transfer evidenced in the growth of experience and skills in the surviving RVFs and in the transfer of skills to competing funds and the financial community more widely as local staff trained in some funds move to other positions in other organisations. As noted elsewhere in this report, the creation of successor funds is under way. The objective of creating a sustainable infrastructure for making private equity investments in the Russian regions has been substantially achieved.

The evaluation team considers that on balance a *Good*[7] rating for fulfilment of objectives is warranted.

4. OVERALL ASSESSMENT

As noted above, the funds were slow to progress initially and the performance of some fund managers gave rise to concern. However, by mid-2002 strong performance by four fund managers in particular led the Bank to consider that they had the potential to raise capital from private investors.[8] One of these had already made a number of successful exits and had begun the process of raising capital from private investors for a follow-on fund. Three others had gained limited exit experience at that stage, but nevertheless held out the promise of future strong performance. It was recognised that the attraction of private capital to funds supported by the Bank would be a key indicator of both the achievement of objectives, and the extent of transition impact. By 2003, therefore, it could be seen that the reorganisation necessitated by a combination of poor performance by some of the original fund managers and the effects of the 1998 banking and financial crisis was beginning to show positive results.

The consolidation by the Bank of some funds under more successful managers effectively increased the capital pool at their disposal. A number of investments were co-financed by two or three of the individual funds enabling the managers to undertake larger-scale investments. The Bank also made it a condition during the process of rationalisation that the fund managers who were retained would supply sufficient investment and management staff in Russia, using expatriate employees where necessary, but without the need to fly in specialist help on a regular basis.[9] The establishment of management teams on Russian territory added to cohesion and

[6] See also section 5.1 below.
[7] The following ratings are possible: *Excellent, Good, Satisfactory, Marginal, Unsatisfactory, Highly Unsatisfactory*
[8] As a first step towards encouraging the realisation of this potential, the Board approved in January 2002 the provision of US$ 27.5 million additional finance to one fund manager. This was followed in February 2006 by Board approval of EBRD participation in a successor fund.
[9] Fly-in senior management and specialist staff had been a feature of some of the early RVFs which was criticised in the mid-term review as being costly and ineffective.

facilitated the monitoring of investments and the negotiation and completion of exits. The reorganisation of the funds and the period of recovery from the 1998 crisis led to some delay in the commencement of an effective exit phase. The Bank agreed to extend the lives of funds where necessary. Some 12 years after the establishment of the first RVF in 1994, the anticipated returns of the funds, based on realised exits and the fair value of remaining investments at December 2005, range from 0 per cent to 13 per cent in gross IRR terms.

Arguably more important than the financial performance of individual funds, is the potential for future success shown by the creation of successor funds. Also very important is the impact of the Russian Venture Capital Association (RVCA) which was founded on the Bank's initiative with RVFs as founder-members. The RVF failings in individual cases which have emerged over the years may be considered to indicate pitfalls to be avoided in the design and operation of future funds, while the successes have demonstrated the viability of properly structured, managed and funded private equity operations in Russia.[10] The results have been achieved at relatively high cost in terms of TC funds and with a delay of 2 to 4 years compared with the life expectancy of 10 years for each fund. It could be asked whether it was appropriate to commence the RVF programme in the early to mid-1990s when market-based behaviour and understanding of the private equity concept were as yet rudimentary. The Bank pioneered the introduction of equity funds in Russia and the results can now be seen not only in some strong financial performance among the surviving funds, but also in skills development and transfer and the growth of successor funds. For these reasons, the evaluation team assigns an overall assessment rating of *Successful* to the RVFs in Russia.

As discussed in the following section, transition impact overall is rated *Good* as realised to date and to have *Excellent* longer-term potential with *Medium* to *High* risk. The foundation of the Russian Venture Capital Association[11] in particular suggests that the impact realised to date will have a lasting influence beyond the EBRD-supported funds. The *Excellent* potential will be realised if the successor funds close as planned and proceed to achieve investment success. It must be recognised that the potential will be achieved only if managers succeed in raising successor funds with majority private capital. The risks must be recognised as *High* because of the uncertain business environment in Russia and, of course, because of the inherently risky nature of private equity investment. The additionality of the RVFs is *Verified in All Respects*. As discussed in section 6 below, total TC disbursements amounted to about US$ 120 million compared with approximately US$ 208 million of donor commitments anticipated at the commencement of the programme. TC performance is rated *Good* overall reflecting the higher than expected level of efficiency achieved in spite of implementation delays aggravated by the 1998 crisis and the restructuring of the RVFs.

5. TRANSITION IMPACT[12] AND ADDITIONALITY

5.1 Transition impact

It should be acknowledged at the outset of the discussion of transition impact that the whole is greater than the sum of the parts. This is demonstrated clearly by the establishment of the RVCA of which the principal RVFs are important participants. From its foundation in 1997 following an

[10] Lessons for future equity funds based on the success drivers identified in this report are presented in section 8 below.
[11] See section 5.1 below.
[12] For an illustration of the transition criteria applied both *ex-ante* at appraisal and *ex-post* in evaluation, please refer to Appendix 2 of the Evaluation Policy Review of 2004 which can be viewed on wwww.ebrd.com/projects/eval/showcase/evalpol04.pdf

EBRD initiative, the RVCA has grown to include 29 full members and 18 associate members.[13] The significance of this development is considered in the following box.

Demonstration effects and frameworks for markets: the significance of the Russian Venture Capital Association.

The initiative to create the RVCA followed the seminar for EBRD Regional Venture Fund managers held in St Petersburg in December 1996. RVCA became an associate member of the European Venture Capital Association (EVCA) in 1997. In 2006 the RVCA has 29 full members including the EBRD, six RVFs and a number of other venture capital and private equity funds and investment houses. Associate members include the EVCA and leading legal and financial consulting firms. Members are required to adopt and adhere to the RVCA Code of Conduct which seeks to promote industry best practice. According to a review of Russian equity and venture capital investments between 1994 and 2004 published by the RVCA in 2005, venture capital and private equity funds invested in excess of US$ 2.4 billion in 353 Russian companies during this period.[14] The review notes that the market in Russia has funds with capitalisation ranging from US$ 4 million to US$ 400 million, each employing from three to 30 experienced professionals. The amount of capital raised from Russian sources has been increasing. In the five-years between 1999 and 2004 some 26 per cent of funds raised came from Russian limited partners compared with 3 per cent for the previous five-year period. It is significant that between 1998 and 2001, ten funds terminated operations, withdrawing an estimated US$ 817 million from the market, cancelling new investment plans and writing off or selling existing investments at a loss to close their portfolios. This underscores the value of the EBRD's commitment to the RVFs during the aftermath of the 1998 financial crisis. As discussed in this report, the transition impact achievements are now becoming manifest.

In order to assess and compare the realised transition impact of individual funds, the evaluation team looked behind the overall financial performance of each fund to the quality of full exits achieved as at 31 December 2004 and developments in 2005. The longer-term transition impact (TI) potential and the risk attached were assessed by considering the likely quality of further exits and success in setting up a follow-on fund. As regards exit, sale to a trade or strategic buyer may be considered to have greater transition impact than sale back to the original owners since the latter would appear to imply that debt funding, perhaps with technical assistance to improve management skills, could have been a more appropriate instrument than private equity. This is particularly so in cases where the fund has sold back to the original owners at a discount to the price originally paid by the fund.

The evaluation team assigned individual ratings for realised TI ranging from *Unsatisfactory* in two cases, to *Excellent* in one case. On balance, and having regard to the greater magnitude of the impact achieved overall in demonstrating the feasibility of private equity investment in Russia, the evaluation team assigns a transition impact rating of *Good* to the RVFs. In view of the success of some fund managers in arranging follow-on funds, the longer-term TI potential of the RVFs is rated *Excellent*, but with *Medium* to *High* risk. The *Excellent* rating is dependent upon the existing funds realising the full upside potential of their remaining exits, and upon the follow-on funds achieving the anticipated level of non-Bank, private contributions on closing.

5.2 Additionality

The additionality of the Bank, as provider of capital, and of the donors, as providers of TC support, was clear at appraisal since funds for small and medium-size enterprise (SME) equity

[13] See www.rvca.ru

[14] *'Obzor rossiysskogo rynka pryamykh i venchurnykh investitsiy 1994 – 2004'*, RVCA, 2005

investment were not available from other sources at the time (early 1990s) and did not begin to materialise from other sources in any significant volume until some years later. Conceptually some interest was beginning to grow in 1996-97 as evidenced by the success of the meeting of fund managers organised at the Bank's initiative in December 1996 in St Petersburg which resulted in the formation of the RVCA. However, major investors did not commit significant volumes of funds until the economic environment began to improve in the late 1990s and early 2000s.

5.3 Environmental impact

The funds are required to implement environmental policies and practices based on the EBRD's environmental procedures for Private Equity Funds. Annual Environmental Reports are prepared by the fund managers and submitted to the Bank. Investee companies are required to comply with Russian environmental and health and safety policies at a minimum. Fund staff have received environmental due diligence training organised by the Bank.

5.4 Country strategy and sector policies

The Bank's strategy for the Russian Federation, approved by the Board in October 1993, noted that the focus of the EBRD's privatisation work would be on the provision of post-privatisation support. The Bank envisaged using instruments that combined technical assistance with the Bank's ability to lend and invest. The RVFs were conceived as such an instrument to provide new capital to assist the restructuring of privatised enterprises, and the development of new private companies, with parallel technical assistance to help with project preparation, implementation and management together with appropriate post-investment advice to investee companies. It became apparent in the early years that many privatised enterprises remained burdened with an old style of management and a reluctance to embrace change. The attention of fund managers, therefore, became more focused on promising private companies run by a new breed of entrepreneurs with the capacity and willingness to adapt to the new economic order. In their structure and execution, the RVFs were fully consistent with the Bank's country strategy and financial sector policies.

6. TC PERFORMANCE

As noted above, the RVFs were set up initially on the basis of a 40 per cent to 60 per cent donor funding to capital ratio. The level of commitment was reviewed by the various donors in the late 1990s and overall TC disbursements have been substantially below the volumes envisaged. Donor resources were used to pay management fees, to meet pre-investment costs including due diligence and environmental review, and to provide a wide variety of post-investment support. Post-investment support included support to management of investee companies on matters ranging from marketing and distribution advice, to management information systems and reporting to international standards.

It was envisaged originally that approximately one-half of the TC funds would be used to meet management fees over the projected 10-year lives of the funds with the balance being used for pre-investment due diligence and post-investment consulting support. As the programme developed, it began to appear that there would be less need for consulting support. It also appeared likely that individual funds would be able to meet at least part of the management fees and consulting costs from the EBRD funds allocated as capital. The level of on-going support was reviewed by donors and, in the majority of cases, the level of commitment was reduced. Most donor support had ceased to be forthcoming by the end of 2003, although some donors terminated arrangements earlier. Whereas around US$ 208 million of donor funding was anticipated initially, total TC disbursements amounted to around US$ 121 million equivalent by the end of 2005 with about US$ 84 million of this paid as fund management fees. The total investment cost of the RVFs as at December 2005 amounted to US$ 257 million. Therefore, each US$ 1 of donor funding has leveraged over US$ 2 of investment compared with the leverage of two-thirds expected at appraisal based on the 40/60 donor funding to Bank capital ratio.

As noted elsewhere in this report, there has been a wide variation in the performance of the funds. In three cases, the returns generated by fund managers to December 2005 were insufficient to cover the amount of TC utilised. However, in four cases the returns net of TC exceeded the amount of TC funds consumed. No additional TC funds were allocated to the follow-on fund approved by the Bank in 2002. The evaluation team assigns a rating of *Good* to TC performance overall since substantially less donor funding has been utilised than envisaged in relation to the level of investment achieved. The higher level of efficiency was reached in spite of the delays that resulted from the 1998 financial crisis and the restructuring of the funds. The *Good* rating is further warranted by the legacy of the follow-on and successor funds which have no TC component. In other words there is evidence that a key objective of technical assistance has been achieved through a number of funds and the RVCA, namely the building of a lasting infrastructure for future private equity operations in Russia.

7. BANK HANDLING

As noted above, investment progress was initially slow with less than €50 million being invested between 1994 and 1997, although the establishment of all 11 RVFs in Russia was not completed until 1996. The Bank undertook a reassessment of the funds in 1998 in order to identify the best-performing managers and to restructure the funds under them where possible. The requirement for technical assistance funding was also re-examined and fund managers were reminded of the objective to achieve demonstration effect by creating a legacy that would be the foundation of a sustainable investment infrastructure. Progress with the restructuring was delayed by the impact of the 1998 crisis. However, between 1997 and 2002 a number of fund managers were replaced, some consolidation of funds was effected to achieve greater critical mass and new fund management agreements were negotiated and signed.

It appears reasonable with the benefit of hindsight to acknowledge that the RVF programme would in all probability have failed without the extensive restructuring efforts undertaken by the Bank. The measures taken were not sufficient to ensure the financial success of all the funds. In two cases, the volume of investments achieved by the end of 2004 was substantially below the amount of EBRD capital committed. On the other hand, the realised returns of the most financially successful restructured fund approached 38 per cent IRR as measured at December 2004 in US$ terms. Nurturing and encouraging the individual funds, while taking action to limit the downside in some cases, has required extensive and time-consuming effort by Bank staff. This has ranged from active participation on the supervisory boards and investment committees of management companies to regular portfolio monitoring.

Since the RVFs have been structured as managed accounts of the Bank, each individual investment by a fund manager is taken onto the Bank's books. This procedure was deemed necessary to give the Bank adequate control from the outset when there were no fund managers with a track record to give the Bank confidence. The evaluation team considers that the Bank took appropriate action to address the underperformance of some fund managers when this began to become apparent and to restructure the funds to boost financial performance and the achievement of transition objectives. As noted above, the Bank was instrumental in the establishment of the Russian Venture Capital Association in 1997 which strives, among other things, to disseminate best practice and EVCA standards in the Russian equity investment industry. The creation of the RVCA was confirmation of the EBRD's pioneering role in setting up the infrastructure for successful private equity investment in Russia. The Bank's staff adopted a hands-on approach and took the initiative with timely corrective action when needed. As the funds have matured, the Bank has actively encouraged the successful fund managers to organise successor funds with amounts contributed from other sources, including private investors to the extent possible, and without TC support. The evaluation team considers that the Bank's handling of the RVFs in Russia warrants an *Excellent* rating overall.

8. KEY ISSUES AND LESSONS LEARNED

In identifying key issues and associated lessons in the section which follows, the evaluation team has paid attention to the drivers that have contributed to the success of the better-performing funds.

8.1 Identifying fund managers with the potential to succeed in early transition environments.

When the RVFs were being restructured, the Bank recognised that it was essential to hire managers who were more than financial engineers and who were prepared to demonstrate some personal commitment to the region by maintaining a properly staffed full-time base there. The use of fly-in senior managers and specialists on a frequent basis proved to be costly and ineffective.

Lessons:

Successful fund managers in early transition environments need a balanced mix of financial engineering, industrial and commercial management skills. Investee companies frequently need hands-on support to realise their underlying investment potential and prepare them for exit via trade sale or sale to a strategic investor. In order to achieve the necessary turnaround, the fund manager must have the capacity to draw on a range of managerial skills in a number of areas.

Ensure that fund managers have the capacity and willingness to provide adequately skilled management and staff in the region in which the fund will operate. Language skills are important, but even more important are the ability and willingness to translate sound business practices to the early or intermediate transition environment. Experience has shown that successful fund managers are able to motivate multidisciplinary teams of expatriate and local specialists.

8.2 Designing funds with potential for critical mass and optimising deal size.

The RVFs were designed originally with an EBRD capital commitment of US$ 30 million each and up to US$ 20 million of donor support. The target deal size was for individual investments of between US$ 300,000 and US$ 3 million. While in theory this could have permitted each fund to establish a portfolio comprising upwards of 10 investments, it became apparent that the demand was for equity investments in excess of the intended ceiling. Moreover, experience in more advanced economies would suggest that medium-sized companies seeking equity investment require larger amounts, while the costs of investing lower amounts in small companies, and the lower potential returns, make smaller investments unviable. In connection with the restructuring, the Bank took the opportunity to consolidate funds in some cases under a single manager, thereby increasing the available pool of capital. The Bank also permitted a number of co-investments on a case-by-case basis which raised the possible deal size.

Lessons:

Ensure that new funds are sufficiently capitalised to achieve a critical mass of investments. With a high initial cost base and longer lead time to exit phase, new funds in early and intermediate transition environments must have sufficient capital to generate a viable pool of investments. Some operating and investee support costs may have to be paid from capital unless TC funds are available. Provision for these should be made in setting the initial capital required by the fund.

In structuring new equity funds, carefully estimate the optimal and the minimum viable deal size having regard to the environment in which the fund will operate. In the present case the funds found it difficult to identify sound investments within the range stipulated in the original programme design, having regard to the desired return on equity and management costs. At the project preparation stage, the Bank should consider making estimates of viable deal size on a country or regional basis. It is important also that funds have adequate capital to make investments of sufficient size without becoming overexposed to a single investee or industry sector.

8.3 Reconciling the pursuit of short-term financial returns with the achievement of longer term transition goals.

In the present case, some fund managers have successfully turned their attention to the raising of successor funds in the closing years of the initial fund. This has required the allocation of senior management time to fund raising initiatives as well as to the pursuit of financially successful exits. In at least one case it appears that the fund manager has been reluctant to devote sufficient resources to new fund raising, perhaps regarding this as a distraction from seeking to maximise the returns from exits while minimising costs. The full transition impact potential of the initial fund may not be realised since qualified and experienced staff are leaving the team as the existing fund runs down.

Lesson:

Seek fund managers who can balance the Bank's longer term transition goals with the pursuit of short term financial returns. Cutting costs in the exit phase by releasing staff may increase short-term profits for the fund manager. However, the successful raising of additional capital for follow-on funds requires the investment of time and resources. It should be recognised that the costs incurred in seeking new finance for investment themselves represent an investment whose returns should materialise through the new portfolio.

8.4 Calculating the true commercial returns generated by TC-supported equity funds.

In advance of half-year portfolio review meetings to assess the credit performance of active funds, the Bank's operation leaders prepare calculations showing the portfolio valuation and investment profitability of each fund. The gross profitability and corresponding gross IRR are calculated. Data are presented for each investment in a fund's portfolio and for each fund overall. The calculations do not take account of the Bank's costs or reflect TC utilisation by the funds. As discussed in this evaluation, the RVFs consumed substantially less TC funding than originally planned. The Bank's willingness to permit certain expenses to be paid from fund capital contributed to higher effective utilisation of TC than expected. As a further consequence the total investment cost of the RVFs was also less than the amount committed at the outset by the Bank. However, as noted above, the Bank's calculations of the funds' financial returns do not currently take into account either the TC costs or the Bank's costs. The evaluation team acknowledges that doing so would result in a less healthy financial picture. However, it is important to calculate pro-forma returns on a full cost basis in order to understand accurately the true profitability of the funds.

Lesson:

The Bank should prepare pro-forma calculations of the returns of equity funds on a full cost basis taking account of the Bank's costs and of the cost of TC inputs. In line with EVCA Valuation Guidelines, the net returns of each equity fund should reflect the payment of management fees and all other professional and ancillary charges paid out in the course of investing, managing and divesting from the investment portfolio. In order to build a full picture of investment returns, costs financed by TC should also be taken into account. The calculation of returns on a full-cost basis should assist the assessment of the effectiveness of programmes and comparison with other instruments and delivery mechanisms.

APPENDIX 1

RVF Investment Objectives

The principal investment objective of the RVFs is to secure a return on equity capital invested in eligible companies in order to finance commercially viable investment projects and thereby to contribute to the restructuring and development of the economy of the region concerned. To this end, the RVFs can invest in accordance with the following policy:

- The minimum investment is US$ 300,000.
- The maximum investment in any enterprise is normally US$ 3 million although the RVFs can make larger investments, including those shared by more than one fund, of up to US$ 10 million.
- The capital provided must be used to finance a new project including associated working capital. The principal criterion is whether the expected return on investment is commensurate with the risks. Eligible projects normally involve the rationalisation, modernisation or expansion of productive capacity.
- At least 75 per cent of the voting shares of the enterprise concerned prior to the RVF's investment must be owned by private shareholders.

The enterprise may operate in any sector of the economy with the following exceptions. RVFs may not invest in enterprises whose principal business is in tobacco or tobacco products, in armaments or where 25 per cent or more of total income is from military-related purposes, in strong alcoholic beverages (exceeding 15 per cent alcoholic content), in gambling, in speculative activities including real estate speculation, in banking, insurance or financial services, in services connected with immoral or illegal activities or activities on the Bank's Environmental Exclusion List.