**Summary of the Operation Performance Evaluation Review**
**Review evaluation of a framework to finance internet-related companies**
**January 2007**

## THE PROJECT

The EBRD's Board approved a framework to finance, through equity, quasi-equity or convertible instruments, various new economy projects. The framework was expected to consist of a number of investments in internet-related companies and was expected to provide an important source of financing for new small and medium-sized enterprises. The concept of a framework was used in order to speed up the approval of sub-projects within the Bank.

The development of this framework resulted from concerns expressed at various levels in the Bank about the need to be more involved in this sector and to support entrepreneurs in the EBRD's countries of operations. With hindsight, this was a belated attempt shortly before the collapse of the "dotcom" boom. The banking team also expressed the view that the framework was not intended to be a strategic initiative, but was a practical tool to facilitate faster approval processes for the Bank during a time of very fast deal-making in the market place.

## PROJECT RATIONALE

The Bank's rationale for involvement in this sector was to support the development of private sector information technology companies through the provision of debt and equity financing. The development of internet and high-technology ventures was seen as important for the region to become and remain competitive in an environment where these emerging industries will play an increasing role in the world economy. The framework was seen as an instrument to stimulate growth of the new economy in the region by positioning the Bank so that it is able to respond to investment opportunities in this field and to support promising management teams.

The development of the internet in the region was seen to have a positive impact on transition through a number of related economic benefits, including:

- competition and market expansion
- demonstration effects.

The EBRD viewed the framework as a necessary complement to other Bank-supported investment approaches in this sector. It was expected that it would give the Bank the ability to finance small direct investments efficiently given the somewhat shorter approval process under the framework umbrella.

The Bank also expected additionality of its investments to be high under the framework, as companies were typically at an early stage of development when obtaining finance is difficult. The volatility of equity prices in this sector had affected investor sentiment and as a result reduced the availability of finance for companies in this sector in the region. Investments in this sector face various risks including, amongst others, the difficulty of forecasting internet penetration and usage in the region.

The Bank saw its role as bringing experienced internet companies and investors to the region, assisting in the creation of new companies, and utilising the Bank's present network of clients and know-how to provide value to new investee companies.

## ACHIEVEMENT OF OBJECTIVES

**To support the development of advanced technology and the internet sector in the region through investment in internet-related transactions, including financial vehicles and direct investments.** The chosen approach was not successful, as it was dependent on the progress of another fund in terms of generating specific investment proposals acceptable to the Bank. The OPER team did not encounter any evidence that direct investments in information technology companies were planned or already tackled at that time. Successful (US) funds working in the technology area used a potential market-driven approach which seems more appropriate in terms of the achieved Return on Investment. The banking team made the comment that internet incubators (investment vehicles that target companies which have the impact to create significant impact) were not uncommon at that time. It appears that the conceptual structuring of the approach was not completed and it can be debated whether the framework investment was in any way additional to Bank-supported equity funds or Bank SME lending with a focus in this business area. The banking team also commented that the framework was simply a delegated approval mechanism to do small deals more quickly if and when they arise. The OPER team does not consider the time-saving feature for approvals as sufficient for the project to be deemed a success. This objective has only been achieved in part.

**To allow the Bank to address a variety of small new economy opportunities while maintaining limited risk exposure to any one project.** Best practice shows that investments in information technology and new media need to have a higher controlling stake by the investor with a corresponding stronger influence on management. The Bank's policy not to take controlling stakes is an issue for successfully managing investments in this sector. This fact needs to be considered carefully when future investments are structured in this sector. Two risk control issues are important in this regard: risk exposure can be limited either by keeping a special focus within the technology sector or by adopting a specific portfolio approach which needs to have a certain minimum size to achieve the risk balance. In this investment operation, neither was the case. The banking team made the observation that it was sound banking practice to discontinue new investments in the framework given the market conditions. The OPER team agrees with this conclusion, however is still of the view that a better risk balance was not achieved due to a lack of focus. This objective has not been achieved.

**To complement the Bank's other efforts in the internet/technology area and allow the Bank to respond to smaller-sized and fast-moving opportunities in an efficient way.** The framework approach was appropriate for reaching this goal, however only a small portion of the approved facility was utilised and therefore, a reasonable risk diversification within the portfolio could not be achieved. The rationale (industrial logic) behind the framework was not evaluated in-house in sufficient detail. The banking team made the point that the Bank is a financial investor and not an industrial sponsor. The set-up of the framework did not really break any new ground in terms of selection focus of sub-projects, however in terms of processing time in-house some reduction of decision time was achieved. The challenge for future operations is to define a governance structure with adequate control but minimal effort for the EBRD. The existing funds co-investment facility/framework of the Bank allows same type of co-investments up to €10 million. This may also require some further coordination in order to minimise the risk of conflicts of interest which may arise in cases where both Bank-supported equity funds and the framework invest in the same company. This conflict occurred in one case in the context of negotiations with shareholders regarding best possible sale/exit strategy which put the Bank in a delicate position versus the initial investment partners. This objective has not been achieved.

## OVERALL ASSESSMENT

The *unsuccessful* overall performance rating of the internet framework operation is based on EvD's internal methodology, which takes into account transition impact, achievement of objectives, environmental impact, company and project performance, Bank handling and investment performance. The overall transition impact is rated *unsatisfactory* based on the predominantly negative outcome of the investments undertaken by the Bank. The project did not have any particular environmental performance objectives and environmental performance and change therefore cannot be rated. The Bank's additionality was *verified at large*. There was a shortage of funding available for the sector and the Bank was therefore additional. The fulfilment of project objectives is rated *unsatisfactory* since only one out of four investments achieved some of the objectives. This is due to the lack of a clear strategy at the outset which should have preceded the process and selection of the appropriate structure (framework or other). The OPER team rates Bank handling as *marginal.* This rating takes into consideration the strong efforts by the banking team to support investments during the problem stages. In the case of one company, the Bank's dedicated support together with the strength of the company's management team ultimately lead to a recovery of the company's financial performance after an extremely difficult trading period.

The framework did not bring the desired impact in the targeted sector, partly due to poor timing at the peak of the internet/technology boom and the fall out caused by the crash through all levels of suppliers and software developers. The Bank could not find a reasonable number of acceptable investment opportunities and hence the intended portfolio approach in terms of risk diversification could not be achieved. The pipeline of investment opportunities at the time of approval was very small and mainly reliant on one company that was seeking to promote investments in the region, which ultimately did not meet the Bank's investment criteria. Questions remain as to whether minority positions in start-up companies are a meaningful approach to creating value. There seems to have been a lack of investment focus in terms of selecting a specific niche or focus in terms of technology.

The OPER team is of the view that the investment strategy should have an industrial logic. This means a focus on specific technologies or value chains depending on the national strength of the underlying basic success factors such as human resources, government policies, infrastructure and location. The difficulties encountered during the earlier investments required substantial use of staff time. In one case, the Bank's discussions regarding the best exit strategy under the framework caused a conflict of interest among the shareholders as the Bank was also involved through a private equity fund that had other exit objectives considering its various investments in the region. Three out of four investments lead essentially to a total loss of capital invested.

## TRANSITION IMPACT AND THE BANK'S ADDITIONALITY

### Overall transition impact

Financial success and survival of the company are key ingredients of transition impact. Since three out of four investments turned into a loss situation, the OPER team rates overall transition as *unsatisfactory.*

### Company impact

Given the fact that the Bank's equity investments under the framework were small minority investments, the Bank did not always have the tools to influence the company's management strongly. This is in line with Bank policies not to take control unless in a workout situation. The OPER team raises the question whether these policies are adequate for successful investments into IT ventures or SMEs. In the one and only successful investment under the framework, the argument can be made that the Bank contributed to introducing proper processes within the firm (corporate governance according to international standards, board appointments etc.) In this case, the Bank's impact on the company can be rated *good/satisfactory.*

### Industry impact

The four investments undertaken within this framework were very small and each one in a different country. Furthermore, there was no particular industrial logic. The impact on the industry was *marginal/unsatisfactory.*

### Impact on the economy as a whole

For the reasons mentioned above, no impact can be measured. Except perhaps in the case of one company, which has been able to achieve a significant turnaround. The OPER team is of the view that measuring even small impacts on the whole economy through IT investments in the countries of operations is of interest to the shareholders of the Bank.

**Country Strategy and sector policies**

The project was consistent with the Bank's Telecommunications, Informatics and Media Sector Policies at the time of Board approval.

**Additionality**

The Bank was additional in the sense that not enough other financial parties were available to provide equity financing for this sector at that time.

## BANK HANDLING

The initial structuring of the Bank's response to the objectives (assisting the region with improvements in the high-tech and internet sectors) was in the view of the OPER team done with limited insights into what was really necessary for a successful set-up of a significant operation in this sector. For instance, not enough time was spent on the definition of a clear strategic focus. More time should also have been allocated to the selection of one or two more industry partners willing to support the Bank with an acceptable deal pipeline. The banking team made the point that significant time was spent finding co-investors, however the timing around the peak of the "dotcom" bubble made this extremely difficult. Furthermore, the search was not limited to industry partners, but also included entrepreneurial teams.

The specific handling of investments after the initial investment was relatively active. The Bank's team put in substantial time and effort to introduce international corporate governance standards and made staff available for board positions and so on. Overall, EvD rates Bank handling as *Marginal*.

## MAIN OPER ISSUES AND LESSONS LEARNED

**An increased focus on media and information technology is required within the Telecom Sector Operations Policy of the Bank.** In order to achieve a shift in emphasis, the new media and information technology sub-sector policy should specifically address the needs of the early, intermediate and advanced transition countries. The new policy also needs to consider the specific circumstances of a country in terms of adequacy of the infrastructure and the proprietary conditions of the information technology and media sector.

**Detailed impact analysis for the IT industry is a crucial prerequisite prior to specific investment operations.** The detailed impact analysis is a prerequisite for properly targeting investments in the IT sector. New country-wide research would facilitate the identification of prerequisites of a positive transition impact landscape. The question must be asked whether a framework is the best vehicle or if perhaps regional specialised equity funds would be a better choice.

**The information technology and new media sector has its own regulatory needs.** Specific issues should be addressed actively and initiated (i.e. information privacy, digital identity management, fraud prevention, consumer protection in e-commerce). In the context of future IT projects, ways of supporting sector reform through special TC assignments should be explored.

**Successful investments in IT require active business development support.** The Bank should consider either allocating more resources from the Telecoms Team for business support to engage itself in the IT sub-sector or finding an appropriate external fund manager with a strong incentive to provide such support.

**The development of a more active role in the IT sub-sector will either require more in-house expertise and dedicated resources or a clear outsourcing mandate.** The Bank will need to dedicate more resources to this sub-sector if it wishes to play a more active role. To some lesser extent this is also true if the Bank wishes to outsource all such activities to regional venture funds managed by industry specialists.

**The Bank's interaction with its clients could be intensified through the introduction of new web-based platforms to facilitate business contacts between Bank clients.** The Bank could be more active in facilitating contacts between its clients and use its country-based resident offices to a higher degree in the support of local and regional meetings with groups of clients.