Special Study

Post-Privatisation Funds

Regional

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Evaluation Department
(EvD)

European Bank
for Reconstruction and Development

SPECIAL STUDY

PREFACE

Evaluation special study

The subject of this special study is the post-privatisation funds programme (regional), a private sector investment operation, which involved the commitment of approximately €169 million to six new private equity funds. The report has been executed by William Keenan, Senior Evaluation Manager. The operation team and other relevant Bank staff commented on an early draft of this report.

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. Fieldwork was carried out in November 2006 and January 2007. The Evaluation Department (EvD) would like to take this opportunity to thank those who contributed to the production of this report.

TABLE OF CONTENTS

ABBREVIATIONS

BD	Banking Department
CEB	Central Europe and the Baltic states
EC	European Community
EU	European Union
EvD	Evaluation Department
FMO	Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden (Netherlands Development Finance Company)
IFI	International finance institution
IPO	Initial public offering
IRR	Internal rate of return
MTR	Mid-term review
OCE	Office of the Chief Economist (EBRD)
OGC	Office of the General Counsel (EBRD)
PPF	Post-privatisation fund
ROI	Return on investment
RVF	Regional venture fund
SMEs	Small and medium-sized enterprises
SRP	Special restructuring programme
TC	Technical cooperation
TVPI	Total value to paid-in capital
US$	United States dollar
XMR	Expanded monitoring report

DEFINED TERMS

the Bank	European Bank for Reconstruction and Development
the Evaluation Team	Staff of the Evaluation Department who carried out the post-evaluation
the Operation Team	Staff in the Banking Department and other respective departments within the Bank responsible for the operation appraisal, negotiation and monitoring, including the XMR
the Project	Establishment of a number of PPFs as managed accounts of the Bank

EXECUTIVE SUMMARY

The Operations
Between 1995 and 1997 the Board approved a number of post-privatisation funds (PPFs) that were to be organised as managed accounts of the Bank. The funds could be regarded as intermediated investment programmes where the Bank acts as the investor of record for sub-investments. The Board approved the establishment of funds in eight countries of operations.

The Evaluation Department (EvD) conducted a mid-term review (MTR) of the PPFs in 2001. The MTR assigned an overall performance rating of "Partly Successful". The present evaluation concludes that, generally, the PPFs have performed better than might have been expected from the findings of the MTR. Nevertheless, it is important for the Bank to retain the lessons of the early less satisfactory experience, especially if considering the introduction of private equity funds in the early transition countries (ETCs). This study therefore brings forward a number of lessons from previous evaluations.

Scope of the special study
The present study considers six PPFs in detail. Since the funds under review are fully exited or in the exit phase, the present evaluation focuses on the investment performance of the funds in order to assess their transition impact and to draw lessons for future private equity operations by the Bank. The effectiveness of the TC support is also assessed.

Overall assessment of performance
Private equity funds in advanced economies often undertake an investment with a view to effecting substantial changes in the underlying business, whether to strategy, operations, management or governance. A key objective of the PPFs was similarly to effect positive changes in the business, management and governance of investee companies. Advancing the mobilisation of additional capital via follow-on funds was a transition-related objective (see section 5). Such mobilisation can be seen as a sign of capital market development.

As discussed in this study, fund performance has varied. Where fund performance is assessed as "Marginal" or "Unsatisfactory", it has been influenced by poor performance of the fund manager or the local investment climate. Section 8 of this study draws lessons that are particularly aimed at future "managed account" activities of the Bank. These should be based on successful factors identified by this and earlier evaluations.

On the basis of its independent assessment, the evaluation team assigns an overall performance rating of "Successful" to the Bank's PPF concept. The evaluation team considers that the "Good" results achieved by three of the funds under review more than outweigh the "Marginal" or "Unsatisfactory" performance of other funds, particularly in view of the successful arrangement of follow-on funds with private capital.

Additionality at appraisal is "Verified in All Respects" because the Bank provided equity finance with a focus on small and medium-sized enterprises (SMEs) that would have been unable to raise private sector financing from other sources. Bank handling is rated "Good" reflecting the level of support given by the banking teams to fund managers. This support was reinforced by occasional corrective actionas well as labour intensive involvement of departments across the Bank (necessitated by the managed account approach).

Transition impact and TC performance

In order to assess 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 2005 and developments in 2006. 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.

The PPFs were launched by the Bank with substantial TC support in an environment where private equity was still a largely alien concept. The need for a high level of technical cooperation (TC) support was acknowledged at approval. In the evaluation team's view, the results demonstrate that the PPF vehicle was appropriate in the circumstances.

The following table summarises the ratings assigned to the funds under review for fulfilment of objectives, transition impact and TC performance.

Table 1: PPF's fulfilment of objectives, TI and TC performance ratings

Fund	Fulfilment of objectives	Transition impact	TC utilised to Dec 2005	Returns net of TC	TC performance
	Rating	Rating[i]	€ million	€ million	Rating[ii]
PPF-1	Good	Good	9.47	47.23	Good
PPF-2	Marginal	Marginal	6.36	-14.36	Unsatisfactory
PPF-3	Good	Good	3.79	16.50	Good
PPF-4	Marginal	Marginal	9.85	-0.26	Marginal
PPF-5	Unsatisfactory	Unsatisfactory	5.62	-8.84	Unsatisfactory
PPF-6	Good	Good	9.16	24.82	Good

Notes: (i) This range is: Excellent, Good, Satisfactory, Marginal, Unsatisfactory, Negative.
(ii) This range is: Excellent, Good, Satisfactory, Marginal, Unsatisfactory, Highly Unsatisfactory.

The evaluation team considers that, overall, a "Successful" performance rating is justified. It was demonstrated that well-managed funds with appropriately targeted investments are capable of achieving good financial results and organising follow-on funds, including private capital.

Summary of key issues and lessons learned

Lessons from the early PPF years

The experience of the PPFs in their early years highlights a number of risk and operational factors that should be considered before launching private equity or venture capital funds in countries where the concept is new. The following are some of the key factors identified:

- Fund managers should have a successful track record and experience gained in a similar emerging market environment. Fund managers must have the resources and commitment to build investment and back office teams locally.
- The transaction costs of equity investment are too high to make smaller investments financially viable. A likely factor in determining the minimum size of private equity deals is the current and prospective economic environment in which the fund is to operate.
- Smaller enterprises that have qualitatively weaker management represent higher risk.
- Identifying suitable equity finance deals becomes even more time-consuming when there is a lack of meaningful information about the business and the financial position of target enterprises.
- A significant proportion of potential private equity deals do not come to fruition because incumbent shareholders/managers are not ready to enter into close partnership, something that entails the sharing of information, decision-making and rewards and that forms the basis of the concept.
- Before launching equity funds in early transition countries, the Bank should carefully consider the relative merits of debt financing programmes. These may be a more suitable vehicle, especially for small enterprises.

Selection and replacement of fund managers

It is important to select fund managers that have the capacity and resources to provide management support to investee companies while also being capable of adequately monitoring the portfolio. When equity investments are supporting business start-ups or expansions, the fund manager needs to adopt a hands-on approach. The fund management team must include sufficiently senior and experienced members to provide high-level management advice and support to investees. The team must also have adequate staff for portfolio monitoring and for research into fresh investment opportunities.

International fund managers must be willing to occasionally provide head office support as well as build local expertise. In a number of cases funds initiated by the Bank have benefited from being able to draw on the experience of an international fund manager. While it is essential for fund managers to commit to building a skilled team locally, it is also important that international principals are willing and able to provide specialist support to the fund or to investee companies when necessary.

The effect of currency exchange rate fluctuations on funds' reported performance

When considering financial performance in the assessment of transition impact, it is recommended to use the currency in which the fund denominates its investments if different from the Bank's reporting currency. Exchange rate fluctuations have led to variations in the calculation of fund returns locally, in-country and by the Bank. It is important to apply a consistent currency benchmark to achieve meaningful comparisons. While the Bank must calculate returns in euros for its own reporting purposes, it may be necessary to calculate returns in another currency (most commonly the US dollar) in order to comparatively assess the performance of funds.

In addition to the above, the study brings forward relevant lessons from earlier evaluation reports.

SPECIAL STUDY
POST-PRIVATISATION FUNDS (REGIONAL)

1. The Project

1.1 The post-privatisation funds (PPFs)

Between 1995 and 1997 the Board approved the establishment of a number of post-privatisation funds (PPFs) that were to be organised as managed accounts of the Bank. The funds can be described as intermediated investment programmes where the Bank acts as the investor of record for sub-investments. The Board approved the establishment of funds in eight countries of operations.

One fund was cancelled before any disbursement took place. Another operation was turned into a direct equity fund with enhanced sponsorship and a larger capital base of which the EBRD's share was 40 per cent. This significantly altered the fund in comparison with the other PPFs which is why it is not considered in the present study.

The Evaluation Department (EvD) conducted a mid-term review (MTR) of the PPFs in 2001. The MTR assigned an overall performance rating of "Partly successful" based on the results achieved to date and an assessment of future prospects. The present evaluation concludes, among other things, that the PPFs have performed better than might have been expected from the findings of the MTR.

Nevertheless, it is important for the Bank to retain the lessons of earlier, less satisfactory experience, especially if considering the introduction of private equity funds in the early transition countries. This aspect is discussed further in section 8 below.

1.2 Evolution of the PPF concept

In 1992 and 1993 the Bank developed the special restructuring programme (SRP) to target enterprises that were in a critical condition but that had the potential, once restructured, to become viable. The SRP was to be carried out primarily through special purpose vehicles established locally in individual countries of operations.

Target companies would be selected by the management of the SRP under the supervision of its board. The latter would consist of qualified and effective directors. The SRP would operate under guidelines approved by the Bank. Sound banking principles would be respected through the rigorous selection of target companies, portfolio diversification and other operating and investment guidelines. It was expected that SRPs would fail in some cases but that these would be compensated by other projects in the portfolio.

This pointed toward a venture capital approach. A degree of state involvement was anticipated. Commitment to the SRP by the countries of operations' government was regarded as a precondition. The Bank would seek private participants where possible. Equity investment was to be the principal instrument while the activities of the SRP would be ultimately targeted at achieving profitable realisation of its investments within a reasonable time period.

Significant support from technical cooperation funds was anticipated. Between 1994 and 1996 the Bank established four SRPs. In the Bank's experience, the SRP concept was not generally successful. Factors leading the unsuccessful outcome included:

- lack of a congruent goal reflected in the differing demands and expectations of the government, the state agency, the fund manager and the Bank
- inadequate due diligence
- poor understanding of equity and valuation concepts.

Through the SRPs, the Bank attempted to stimulate medium-sized enterprise restructuring by means of equity investment in central Europe and the Baltic states (CEB) where the implementation of privatisation programmes had been slow. From late 1995 the Board approved a number of PPFs that were similar to SRPs but with one significant difference: whereas in the case of SRPs the Bank sought to work in partnership with sovereign states and government agencies, the PPFs, as their name suggests, targeted privatised firms. This meant that the fund manager and the Bank could negotiate entry values and shareholders agreements with private owners. The PPF managers were encouraged to act in a commercial manner following sound banking principles.

They were also encouraged to employ a proactive approach and intensive monitoring in managing the investments in SMEs. Substantial TC funds were allocated to improve returns and lower risks to bankable levels by financing management fees as well as pre- and post-investment technical assistance.

1.3 The PPFs under review

The following table gives an overview of the capital committed and the levels of investment made.

Table 2: PPFs at 31 December 2005

Funds	Total capital committed	EBRD capital committed		Total investment cost	No. of investee companies
	€ million	€ million	% of total	€ million	
PPF-1	44.00	25.00	57%	38.25	12
PPF-2	42.00	30.00	71%	34.28	11
PPF-3	31.12	30.00	96%	22.71	8
PPF-4	33.00	30.00	91%	23.87	9
PPF-5	40.00	30.00	75%	8.71	6
PPF-6	26.25	24.00	91%	20.60	10

As noted above, the funds are organised as managed funds of the Bank. Consequently, each individual investment by a fund is held on the Bank's balance sheet. The funds were initially set up with a 10-year life cycle. In one case the fund's life was curtailed because of poor performance. In other cases extensions were granted to permit fund managers to complete the process of divestment from the fund portfolios.

In order to encourage fund managers to optimise financial returns, the remuneration structure included the incentive of 'carried interest', which is common for venture capital type funds. Carried interest is the manager's share of profits from investments made by the fund. As is typically the case, carried interest became payable to PPF managers only after the EBRD had collected its original investment plus a preferred return. As a result of the slow and somewhat difficult start experienced by the PPFs, the first carried interest payments were not made until 2005.

1.4 TC support

It was anticipated at the outset that substantial donor funding would be required to meet the cost of management fees and external consultants. The following table shows the expected donor funding and the amounts disbursed to December 2005. TC performance is assessed in section 6 below. Section 7.1 discusses the impact of TC on fund returns and profitability for the Bank.

Table 3: PPFs TC disbursements to 31 December 2005

Funds	Expected donor funding	TC disbursed		
		Total	Management fees	External consultants
	€ million	€ million	€ million	€ million
PPF-1	10.00	9.47	4.00	5.47
PPF-2	8.00	6.36	2.85	3.51
PPF-3	3.79	3.79	1.90	1.89
PPF-4	20.00	9.85	5.87	3.98
PPF-5	15.00	5.62	3.97	1.65
PPF-6	16.00	9.16	7.18	1.98

1.5 Scope of the special study

Since the funds under review are fully exited or in the exit phase, the present evaluation focuses on the investment performance of the funds in order to assess their transition impact and draw lessons for future private equity operations by the Bank. Sustainability, as demonstrated by the establishment of a follow-on fund including private capital, is an important measure in achieving transition impact. The effectiveness of the TC support is also assessed.

2. Rationale for the PPFs

In the 1990s there was a serious shortage of capital to support the restructuring and growth of privatised enterprises in the Bank's countries of operations. This was especially evident in countries that had adopted means of privatisation, such as voucher privatisation, where creation of private ownership did not induce the flow of financial resources to enterprises in exchange.

Moreover, the idea of sharing risks and rewards, something that underpins private equity, had been largely buried during the command economy years. The Bank and donors recognised that new private shareholders had little or no money to invest in their enterprises and lacked the experience and competence to institute effective governance. The PPF's rationale was premised on their contribution to restructuring and governance at enterprise level as well as their demonstrating the effectiveness of private equity in a market economy.

3. Achievement of objectives

While there were some differences in structure and profile among the PPFs, they generally shared two principal objectives at appraisal. First, they were meant to achieve a return on capital commensurate with the risks associated with the investments made by the funds. Secondly, PPFs were designed to provide fresh equity, effective governance and management assistance to enterprises that were unable to raise private equity capital at the time. The fulfilment of objectives by each fund is assessed in the following sections.

3.1 Return on capital commensurate with risks

The funds under review are either fully exited or nearing exit after an extension that had been granted to allow for completion of the process. Achievement of this first objective can therefore be assessed by considering actual financial performance. The following table shows the returns made by each fund to December 2005. This is measured using the two yardsticks commonly applied to equity funds: the internal rate of return (IRR) and the ratio of total value to paid-in capital (TVPI).[1]

Table 4: PPFs rates of return December 2005

Fund	Fund IRR %	Fund TVPI	EBRD IRR %	EBRD TVPI
	Net asset value based	Net asset value based	Fair value based	Fair value based
PPF-1	22.03%	2.48	22.80%	2.36
PPF-2	-5.70%	0.77	-9.00%	0.69
PPF-3	16.66%	1.89	10.56%	1.48
PPF-4	8.96%	1.40	2.24%	1.08
PPF-5	-17.80%	0.63	-17.57%	0.63
PPF-6	37.06%	2.65	32.51%	2.32

The following commentary addresses each fund individually.

PPF-1: Objective achieved

The fund had total available equity of €44 million. At appraisal a portfolio of around 27 investments was projected, ranging between €1.5 and €2 million for each investment. On the basis of this portfolio an IRR of 20 per cent was projected. The actual outcome as at December 2005 amounted to a gross IRR of 22.03 per cent and a TVPI of 2.48 indicating that the fund had returned to investors 2.48 times the amount invested.[2] These returns were achieved on a portfolio of 12 investments of between €80,000 and €6.7 million.

PPF-2: Objective not achieved

The fund’s total capital amounted to €42 million. A portfolio of 25 investments was projected with a return of 20 per cent on a portfolio basis. The fund made 11 investments of between €1 million and €4.5 million and had exited fully from nine of these by December 2005. At that date it recorded a TVPI of 0.77 indicating that it expected not to be able to return to investors the full amount invested. The fund had a negative IRR of -5.7 per cent at December 2005.[3]

PPF-3: Objective achieved

The fund’s capital of €31.125 million was created in 1988 by combining the resources

[1] A TVPI in excess of 1 indicates a positive return on investment over the holding period taking into consideration both realised proceeds and the valuation of unrealised portfolio investments.
[2] At December 2006 the gross IRR was 22.59 per cent and TVPI 2.61.
[3] The IRR was -7.7 per cent at December 2006.

of two funds which were under common management. No detailed projections were put forward at appraisal. The combined PPF made eight investments and recorded a TVPI of 1.89 and a gross IRR of 16.66 per cent at December 2005.[4]

PPF-4: Objective partly achieved
At approval in February 1996 a portfolio of 20 investments was projected from the fund's total capital of €33 million. A return of 20 per cent was projected on a portfolio basis. The fund made nine investments and recorded a TVPI of 1.4 at December 2005 with a gross IRR of almost 9 per cent, which is substantially less than projected and less than the returns achieved by a number of more successful funds.

PPF-5: Objective not achieved
At approval in December 1997 a return of 20 per cent was forecast for the fund based on total available capital of €40 million and a portfolio of 12 investments with an average size of €3.3 million. Six investments were made for a total investment cost of €8.7 million. The Bank decided in 2002 that no further investments should be made because of the poor performance of the original fund manager and the investments,. Overall, the fund achieved a TVPI of 0.63 and a negative IRR of 17.8 per cent.

PPF-6: Objective achieved
This fund made 10 investments and recorded a TVPI of 2.65 at December 2005 with a gross IRR of 37 per cent, making it the most successful of the funds under review in financial terms. A follow-on fund was established in 2005 when approval was given for the Bank to commit up to US$ 25 million to the expected US$ 75 million of the new fund.

3.2 Provision of new equity, effective governance and management assistance

This objective is closely related to the transition objectives of the PPF concept as funds were intended to provide management assistance, know-how transfer and long-term capital to privately owned SMEs. This would contribute to the expansion of the SME sector and demonstrate the effectiveness of private equity. The transition impact of the funds under review is discussed more fully in section 5.

PPF-1: Objective achieved
The fund management team took a hands-on approach in guiding investee companies. In addition, TC funds were utilised to provide post-investment support using external consultants in such areas as general management training, human resources, financial management, marketing, technical assistance and strategic planning.

PPF-2: Objective partly achieved
The current fund manager, who is winding up the fund, inherited a poorly performing portfolio from the original manager. The new fund manager did not succeed in turning the investee companies around due to lack of resources and specific knowledge in critical areas. Only three out of eleven investments showed a positive return as at July 2006. However, it should be noted that in two or three cases the fund manager's entrepreneurial ability contributed strongly to the business development of the investees.

[4] The IRR was 16.59 per cent at December 2006.

PPF-3: Objective achieved
The fund manager provided active support to investee companies, contributing to increased shareholder value in most cases. One of eight investments was written off following the bankruptcy of the investee company's major customer and two others failed to return the full investment cost. In the more successful cases the active involvement of the fund manager in the investee companies helped to introduce good management practices and governance.

PPF-4: Objective partly achieved
The fund manager succeeded in turning around one company that was close to bankruptcy by taking control of the operation and replacing senior management. This became the most successful investment in the portfolio financially. However, despite encouraging the management of investee companies to invest in the modernisation of production equipment and adopt modern management techniques, four out of nine investments failed to recover the full investment cost. In a fifth case the investment cost was covered only marginally.

PPF-5: Objective not achieved
Although the fund manager provided management assistance to investee companies, the fund invested only 29 per cent of available capital in five years. The fund's six investments all performed below expectations with three of the six producing a negative return.

PPF-6: Objective achieved
The fund manager was active in all investee companies, participating in supervisory boards and mobilising TC funds to support restructuring, modernisation and expansion.

3.3 Fulfilment of objectives – ratings table

Table 5: Fulfilment of objectives

PPF-1	**PPF-2**	**PPF-3**	**PPF-4**	**PPF-5**	**PPF-6**
Good	*Marginal*	*Good*	*Marginal*	*Unsatisfactory*	*Good*

The PPFs are a more heterogeneous group than the Regional Venture Funds in Russia, in part because of:

- the differing levels of co-investment by fund management firms
- the varying profiles of fund managers in terms of size and structure
- the presence of the European Union (EU) as a co-investor in two of the funds and of the Netherlands Development Finance Company (FMO) in another
- the amount and accessibility of TC funding.

The economies of the various countries also differed. Nevertheless, the evaluation team feels that it is appropriate to assign a rating for fulfilment of objectives to the PPFs collectively because of their shared rationale and goals. On balance the fulfilment of objectives by the PPFs is rated "Good", having taken into consideration the overall financial performance and the legacy of the follow-on funds.

4. Overall assessment

Private equity funds in advanced economies often undertake an investment with a view to effecting substantial changes in the underlying business, whether to strategy, operations, management or governance. A key objective of the PPFs was similarly to effect positive changes in the business, management and governance of investee companies. A transition-related objective (see section 5) was to encourage the mobilisation of additional capital via follow-on funds. Such mobilisation can be seen as a sign of capital market development.

As discussed in this study, fund performance has varied. Where fund performance is assessed as marginal or unsatisfactory, this has been influenced to differing degrees by poor performance of the fund manager or the local investment climate. Section 8 of this study draws lessons that are aimed in particular at any future "managed account" activities of the Bank, based on the identification of successful measures by this and earlier evaluations.

On the basis of its independent assessment, the evaluation team assigns an overall performance rating of "Successful" to the PPF concept as developed by the Bank. The evaluation team considers that the "Good" results achieved by three of the funds under review more than outweigh the "Marginal" or "Unsatisfactory" performance of other funds, particularly in view of the successes in arranging follow-on funds with private capital.

The following table summarises the transition impact and TC performance ratings assigned by the evaluation team to the funds under review and discussed in sections 5 and 6 below. Additionality at appraisal is "Verified in All Respects" as in each case the Bank provided equity finance with a focus, reflected in the funds' investment policies, on SMEs unable to raise private sector financing from other funds or institutions, including private equity funds supported by EBRD.

Bank handling is rated "Good", reflecting the level of support given by the banking teams to fund managers, reinforced by corrective action when necessary, and the labour intensive involvement of departments across the bank necessitated by the managed account approach.

Table 6: PPFs Fulfilment of objectives, TI and TC performance ratings

Fund	**Fulfilment of objectives**	**Transition impact**	**TC utilised to Dec 2005**	**Returns net of TC**[i]	**TC performance**
	Rating	Rating[ii]	€ million	€ million	Rating[iii]
PPF-1	Good	Good	9.47	47.23	Good
PPF-2	Marginal	Marginal	6.36	-14.36	Unsatisfactory
PPF-3	Good	Good	3.79	16.50	Good
PPF-4	Marginal	Marginal	9.85	-0.26	Marginal
PPF-5	Unsatisfactory	Unsatisfactory	5.62	-8.84	Unsatisfactory
PPF-6	Good	Good	9.16	24.82	Good

Notes: (i) See appendix 3.
(ii) This range is: Excellent, Good, Satisfactory, Marginal, Unsatisfactory, Negative.
(iii) This range is: Excellent, Good, Satisfactory, Marginal, Unsatisfactory, Highly Unsatisfactory.

As discussed above, the evaluation team considers that a "Successful" overall performance rating is warranted since on balance it was demonstrated that well-managed funds with appropriately targeted investments are capable of achieving good financial results and organising follow-on funds, including private capital.

5. Transition impact and additionality

In order to assess the realised transition impact of individual funds, the evaluation team looked at developments in 2006 as well as the quality of full exits achieved as at 31 December 2005. The longer-term 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 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 equity. This is particularly true for cases where the fund has sold back to original owners at a lower price than originally paid by the fund.

The following table summarises the position regarding exit numbers as at 31 December 2005.

Table 7: PPFs investments exited at 31 December 2005

Funds	No. of investee companies			
	Total	Full exits	Part exits	Not exited
PPF-1	12	8	0	4
PPF-2	11	9	1	1
PPF-3	8	5	2	1
PPF-4	9	8	0	1
PPF-5	6	6	0	0
PPF-6	10	2	1	7

PPF-1: "Good" TI realised to date; "Good" potential with "Medium" risk

By December 2005 the fund had fully exited from 8 of 12 investments made originally between 1997 and 2000. In three cases the gross IRR was below 10 per cent. However, strong returns in five cases resulted in a gross IRR on the realised portfolio of almost 26 per cent. Based on the fair value of the remaining investments, the gross IRR of the entire portfolio was estimated at approximately 22 per cent after allowing for a probable loss on one investment.

The fund has been managed by a local team that was led by an expatriate managing director who was supported by two local senior investment officers and junior staff. The fund manager's parent company has been supportive in providing expert assistance in turning around companies in the portfolio. The fund manager has built a strong reputation locally. The EBRD Board has approved Bank participation in a follow-on fund with the same manager.

PPF-2: "Marginal" TI realised to date; "Marginal" potential with "Low" risk

The fund had fully exited from 9 out of 11 investments by December 2005 with a positive return in only two cases. As noted above, the current fund manager inherited a poorly performing portfolio from the original fund manager and was unable to make a significant impact on investment performance despite making two relatively more successful investments in recent years.

The Bank has agreed to extend the life of the fund pending the resolution of two legal disputes. However, the fund managers are understood to be turning attention to other investment activities following the wind-up of the fund and no follow-on fund is envisaged.

PPF-3: "Good" TI realised to date; "Good" potential with "Low" risk
The key personnel of the fund management team established a follow-on fund in 2002 to invest in the same region. The present PPF invested in eight companies and had exited fully from six of these by December 2005. One investment was written off. The remaining investments were fully divested during 2006. Five investments achieved IRRs of between 8 per cent and 65 per cent.

PPF-4: "Marginal" TI realised to date; "Marginal" potential with "Low" risk
The fund has exited from all but one of the nine investments. One small investment was written off and three others were unprofitable. Only one investment achieved an IRR in excess of 20 per cent.

PPF-5: "Unsatisfactory" TI realised to date; "No" potential with "Low" risk
The Bank instructed the fund manager to cease making new investments and to focus on exits because of poor overall performance. Only 29 per cent of available capital was invested in six companies over a five-year period. The final exit took place in June 2004. Of €8.7 million invested in total, only €5.5 million was returned to the fund.

It should be acknowledged that the fund had to contend with a difficult environment when it began operations. However, problems were exacerbated by frequent senior management changes and reportedly a lack of support from the fund manager's head office.

PPF-6: "Good" TI realised to date; "Good" potential with "Medium" risk
As at December 2005 this PPF had exited fully from two out of ten investments and had achieved a partial exit from one. Three investments in the remaining portfolio are recognised to be underperforming while one is believed to have potential for a substantial financial return, possibly through an initial public offering (IPO). A follow-on fund is fully subscribed with €80 million of capital.

5.1 Additionality

Additionality at appraisal is "Verified in All Respects" for each of the funds under review. A common theme at appraisal was the overall shortage of equity funding for SMEs. The performance of the funds has varied, partly because of the differing investment climates and uneven fund manager performance. However, the additionality of the funds in making available long-term finance coupled with technical assistance to support growth and expansion was high.

5.2 Environmental impact

The fund managers were required to follow the Bank's environmental procedures for private equity funds and to submit annual environmental reports to the Bank. Fund management agreements and fund investment policies incorporated detailed environmental procedures. As well as receiving annual environmental reports, the Bank monitored fund managers' performance in relation to environmental matters. This was done in individual cases through participation in fund investment committees and supervisory boards.

In July 2006 EvD published an evaluation special study entitled "Achieving the Bank's Mandate through Financial Intermediaries". With regard to environmental risk categorisation, the study concluded that the Bank should consider raising the bar to European Union or World Bank standards for investments by equity funds.

6. TC performance

As with the Regional Venture Funds in Russia, a significant level of technical assistance funding is required in order to successfully establish PPFs. TC funds were required to meet the cost of management fees and also pay for external consultants to assist with pre-investment due diligence and to provide post-investment advice to investee companies. The following table summarises the volume of TC disbursements by the funds under review compared with the expected donor funding at appraisal, the total capital committed and the actual total investment cost of each fund.

Table 8: TC utilisation by PPFs at 31 December 2005

Funds	Total capital committed	Expected donor funding	Total investment cost	TC disbursed		
				Total	M'mnt fees	External consult's
	€ million	€ million	€ million	€ million		
PPF-1	44.00	10.00	38.25	9.47	4.00	5.47
PPF-2	42.00	8.00	34.28	6.36	2.85	3.51
PPF-3	31.12	3.79	22.71	3.79	1.90	1.89
PPF-4	33.00	20.00	23.87	9.85	5.87	3.98
PPF-5	40.00	15.00	8.71	5.62	3.97	1.65
PPF-6	26.25	16.00	26.60	9.16	7.18	1.98

The EvD's 2001 MTR noted that the study team (including consultants hired to examine the structure and performance of five PPFs) "has the impression that the role held by fund managers in these companies was generally greater than what could have been expected by their part in the ownership of these companies. Daily interventions were the norm not only at the beginning of the relationship but at all times. The companies are generally in a state of professional dependence with respect to the funds and any decisions are discussed thoroughly with the funds."[5]

[5] The MTR also noted with regard to fund management teams: "Most of the time they have to micro-manage the investee companies introducing tools of management that didn't exist before. The introduction of planning, budgeting, cost accounting or simply IAS required a hands-on approach and a follow up that only fund staff can bring to the investees as a daily routine. Concurrently, they contributed to the monitoring of consultants in specific fields such as marketing study or production improvement."

As noted above, the financial performance of the funds has varied. At December 2005 the gross returns of four funds were positive. In one case, however, the returns generated were insufficient to cover fully the amount of TC utilised.

During fieldwork for this special study, the evaluation team interviewed an EU representative responsible for several funds and a national government representative who was also a member of a fund supervisory board. The study team observed that the government focused less on financial returns and more on stimulating growth among the investee companies measured in terms of output and employment growth.

However, the EU representative praised the quality of the advice given by the EBRD which helped orient the fund in such a way as to achieve an effective balance between financial return for the fund and enterprise growth. In the evaluation team's view, fund financial performance can be seen as reflecting the success of enterprise growth since fund returns are a reflection of the fund manager's success in increasing shareholder value. Financial performance and the creation of follow-on funds are therefore reliable proxy measures of the success of technical assistance. The evaluation team assigns TC performance ratings to the funds under review as shown in the following table.

Table 9: TC performance – ratings table

PPF-1	PPF-2	PPF-3	PPF-4	PPF-5	PPF-6
Good	*Unsatisfactory*	*Good*	*Marginal*	*Unsatisfactory*	*Good*

The PPFs were launched by the Bank with substantial TC support in an environment in which private equity was still a largely alien concept. The need for a high level of TC support was acknowledged at approval. In the evaluation team's view, the results demonstrate on balance that the PPF vehicle was appropriate in the circumstances.

7. Bank handling

7.1 Profitability for the Bank and the impact of TC on returns

In projecting rates of return for PPFs, the Board approval documents generally anticipated a gross IRR of 20 per cent on a portfolio basis. Achieving a return on capital commensurate with the risks was an operational objective. This objective also had transition overtones since good financial performance was likely to demonstrate the viability of equity funding to other finance providers as well as encourage private sources to participate in follow-on funds. Since the operations under review were approved between 1995 and 1997, the approval documents did not apply the Bank's projected profitability model which was adopted around 2000.

It is, however, reasonable to adapt a benchmark from a Board document concerning a recently approved regional fund in order to assess the PPFs' contribution to the Bank's profitability. The new fund is to have a primary focus on information, communication and technology projects. The Board document expresses the expected contribution to the Bank's profitability as an anticipated IRR of 9.6 per cent before risk adjustment.[6] The evaluation team calculated each PPF's IRR to 31 December

[6] For comparison the follow-on fund to one of the PPFs had projected profitability of 9 per cent at approval.

2005, EBRD direct costs and cost of funds as posted in the Bank's records.[7]

The following table shows the EBRD return on investment (ROI) for the funds individually as well as aggregated. It also shows the EBRD ROI net of TC which takes account of TC-funded management and consultancy fees, giving a more realistic picture of the true net IRR.

Table 10: PPFs EBRD ROI to 31 December 2005

Fund	EBRD ROI	EBRD ROI net of TC
PPF-1	21%	12%
PPF-2	-14%	-19%
PPF-3	7%	4%
PPF-4	-1%	-9%
PPF-5	-23%	-38%
PPF-6	35%	17%
Overall	**8%**	**0%**

Not surprisingly, the variation in contributions to profitability by the funds reflects the variations in gross returns which they recorded. Of particular interest is the overall result. As shown in the above table, the overall ROI to the Bank was 8 per cent. This compares favourably with the projected return of 9.6 per cent for the recently approved fund, especially when one considers that a new fund, drawing on past experience, should achieve higher returns than the Bank's early efforts to introduce private equity funds to the region.

The overall EBRD ROI net of TC of 0 per cent indicates that the TC funds helped to defray significant costs represented by management fees and pre- and post-investment consultant support, permitting the Bank to earn a return on capital broadly in line with current expectations.[8]

7.2 Use of the "managed account" vehicle

As noted above, PPFs were "managed accounts" of the Bank rather than separate legal entities. The managed account vehicle arose from the Bank's desire to adopt a more active approach to equity investment, particularly in the financing of larger SMEs, in an environment whose constraints made the establishment of a fund as a legal entity impractical, at least for the time being.

There was perceived to be no apparent benefit from setting up an off-shore subsidiary of the Bank for the purpose, at least for as long as the Bank remained the sole or principal investor and relied on substantial TC support from the European Commission (EC), EU and other donors. The approach was seen to have a number of significant additional benefits:

- The Bank as a direct investor would continue to enjoy its privileges and immunities.
- The costs involved in setting up and running a separate legal entity would be saved.

[7] 31 December 2005 is the latest year-end date for which full figures were available for fund cash flows.

[8] As noted above, TC funding was available for management fees in the first three to four years of a fund's life in most cases.

- The administrative and financial follow-up was expected to be simpler without an intermediary.

While the managed fund approach may have realised the first two, it has at times proved administratively complex. The mechanism's inherent complexity was reflected in observations about Bank performance made by fund managers and donor representatives interviewed by the evaluation team. The Bank's contribution at supervisory board and investment committee level was praised.

However, some criticism was levelled at the lengthy reconciliations required to agree euro-denominated historical cashflows that formed the basis for calculating carried interest and other payments. Some Bank operation leaders (OLs) involved with the funds also pointed to time-consuming reconciliation procedures which could perhaps have been simplified by early adoption of a standard methodology.

Nevertheless, the evaluation team takes note of the positive remarks made by a number of participants. It therefore considers that the banking teams gave good support to fund managers and took appropriate corrective action when necessary. Bank handling is rated "Good".

8. Key issues and lessons learned

This section identifies key issues and associated lessons and thereby acknowledges the measures contributing to the success of the better-performing funds.

8.1 Issues and lessons from the early PPF years

This evaluation concludes, among other things, that the overall performance of the PPFs was successful. The EvD's 2001 MTR of the PPFs assigned a "Partly successful" performance rating based on the results achieved to that date and the assessment of future prospects. In 2001 the volume of investments by the funds was below that anticipated at appraisal and the financial prospects did not look promising.

Since 2001, three of the six funds have performed sufficiently strong to outweigh the small gross return of one fund and the negative returns of two others. The MTR drew attention to the difficulty of developing a venture capital and private equity approach in central and eastern Europe as reflected in the slow pace of investment during the first years of the funds' operation.

Although the PPFs may now be judged to have been successful, the evaluation team stresses the importance of retaining the lessons of the early experience. It will be especially important to keep these lessons in mind when considering the launch of venture capital and private equity funds in the ETCs.

Lesson
Review of earlier PPFs highlights a number of risk and operational factors that should be considered before launching private equity or venture capital funds in countries where the concept is new. The following are some of the key factors identified:

- Fund managers should have a successful track record and experience gained in a similar emerging market environment. Fund managers must have the resources and commitment to build investment and back office teams locally.
- The transaction costs of equity investment are too high to make smaller investments financially viable. The economic environment, whether current or prospective, likely determines the minimum economic size of private equity deals.
- Smaller enterprises that have qualitatively weaker management represent higher risk.
- Identifying suitable deals for equity finance becomes even more time-consuming when there is a lack of meaningful information about the business and financial position of target enterprises.
- A significant proportion of potential private equity deals do not come to fruition because incumbent shareholders/managers are not ready to enter into close partnership, something that is crucial to the concept and entails the sharing of information, decision-making and rewards.
- Before launching equity funds in ETCs, the Bank should carefully consider if debt-financing programmes are suitable vehicles, especially for smaller enterprises.

8.2 Selection and replacement of fund managers

The selection of fund managers was unquestionably successful in the case of three of the six funds under review. This is evidenced by the financial performance of the funds, indicating that Bank and fund managers cooperated well in turning around and/or developing investee companies. It is further evidenced by the creation of follow-on funds in three cases that involved Bank participation and attracted private capital.

In other cases the selection was less successful. In one instance the Bank instructed the fund manager to cease new investments and focus on winding up the fund. In a second instance the fund manager was replaced. Although, in this case, it was possible to salvage some of the poorer investments, the new fund manager only had limited resources for portfolio monitoring and identifying new investment opportunities.

In the third case the fund manager left little legacy of locally trained staff after exiting the fund investments. Nevertheless, the evaluation team understands that a number of staff are attempting to stimulate interest in a new fund.

Lessons
It is important to select fund managers that have sufficient capacity and resources to provide management support to investee companies and adequate portfolio monitoring. When equity investments are supporting business start-up or expansion, the fund manager needs to adopt a hands-on approach. The fund management team must include a sufficient number of senior and experienced members in order to provide high-level management advice and support to investees. The team must also have adequate staff for portfolio monitoring and research into new investment opportunities.

International fund managers must be willing to provide occasional head office support as well as build local expertise. In a number of cases funds initiated by the Bank have benefited from drawing on the experience of an international fund manager. While it is essential for fund managers to build a skilled team locally, it is also important that international principals provide specialist support to the fund or to investee companies.

8.3 The effect of currency exchange rate fluctuations on funds' reported performance

The Bank accounts for its activities in euro, its reporting currency. Disbursements and receipts by funds have been quoted in euros, US dollars or the local currency. In the case of the PPF-1, for example, disbursements took place largely in US dollars in the earlier years when the country's economy was predominantly "dollarised". In later years, a number of disbursements were made in euros. Also, a number of significant receipts, for example dividend receipts and exit proceeds, were transacted in the local currency.

Although the use of multiple currencies in equity funds is uncommon in developed economies, it will probably persist in transition economies where the local currency has yet to gain sufficient strength. Currency exchange fluctuations may significantly affect the reported performance of fund investments. It is of course necessary for the Bank to record all transaction in its reporting currency in its own books.

However, when considering transition impact and demonstration potential, it may be appropriate to assess fund performance in a currency, such as US dollars, that reflects the currency convention of the country of operation. If fund returns are considered only in euros in countries where returns are measured in US dollars, fund performance may be over- or understated when compared with other funds, depending on currency movements during the investment-holding period.

Lesson
When considering financial performance in the assessment of transition impact, it is recommended to use the currency in which the fund denominates its investments if different from the Bank's reporting currency. Exchange rate fluctuations have led to variations in the calculation of fund returns locally, in-country and by the Bank.

It is important to apply a consistent currency benchmark to achieve meaningful comparisons. While the Bank must calculate returns in euros for its own reporting purposes, it may be necessary to calculate returns in another currency as appropriate (most commonly the US dollars) in order to assess performances comparatively.

8.4 Lessons from the 2005 evaluation special study of the Russian Regional Venture Funds

The following lessons from the 2005 evaluation special study on Regional Venture Funds in Russia are also of relevance to any future PPFs or similarly managed accounts that may be organised by the Bank.

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.

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. Adequate provision should be made in setting the initial capital required by the fund.

In structuring new equity funds, it is recommended to carefully estimate the optimal and the minimum viable deal size, taking into consideration 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 and match the desired return on equity and management costs. At the project preparation stage, the Bank should consider making viable size estimates on a country or regional basis. It is also important that funds have adequate capital to make sufficiently sized investments without becoming overexposed to a single investee or industry sector.

It is recommended to seek fund managers who can balance the Bank's long-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, successfully raising additional capital for follow-on funds requires the investment of time and resources. It should be acknowledged that the costs incurred in seeking new finance for investment represent an investment whose returns should materialise through the new portfolio.

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 European Private Equity and Venture Capital Association (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 TCs should also be taken into account. The calculation of returns on a full cost basis should assist in assessing the effectiveness of programmes and in the comparison with other instruments and delivery mechanisms.

8.5 Other lessons from an earlier evaluation report

In order to achieve a comprehensive review, the following lessons are brought forward from an earlier evaluation report.

Where possible the Bank should seek commitments to provide TC funds for long-term projects from multiple donors. A review of priorities and resulting policy change may affect the availability of TC funds to a project supported by a single donor, potentially jeopardising future operations. Firm long-term commitments from single donors may not be possible for political or budgetary reasons. The Bank should attempt to mitigate the risk to long-term projects by seeking TC commitments from more than one donor.

Design investment policies to facilitate the achievement of project objectives. Overly restrictive conditions can impede the performance of fund managers and thereby hinder the achievement of performance and transition objectives. While it is essential to include appropriate safeguards and controls, investment policies should reflect the realities of the market.

Build a sufficient time horizon into the structure of the fund. Especially in countries at an early or intermediate stage of transition, unexpected delays can occur as a result of political, economic and regulatory developments. Sufficient time must also be allowed to identify local partners, gain familiarity with business practices and deal with various organisational matters. It is important when structuring a new fund to ensure the availability of adequate resources to cover the set-up period.

Structure equity funds to give the Bank sufficient leverage over fund managers and the conduct of investee companies. By structuring a fund to allow the Bank to exercise influence through the supervisory board and investment committee, changes in the business practices of investee companies can be encouraged leading to better transparency and accountability and stronger governance. The Bank's position of influence can be used to overcome resistance to change in difficult environments.

The Bank should insist on a realistic strategy for exit from investee companies. In early and intermediate transition environments where capital markets are underdeveloped and illiquid, it is not realistic to propose exit via the local market. A strong shareholders' agreement can allow the Bank and the fund manager to influence the timing of exits to enhance investment returns.