SUMMARY OF THE OPERATION PERFORMANCE EVALUATION REVIEW

The project
This Operation Performance Evaluation Review (OPER) focuses on two equity funds (funds A and B) that were part of a series of funds under common management dating back to the early 1990s. The funds were launched with EBRD participation to make investments in small and medium-sized private enterprises. The funds attracted contributions from a number of private investors.

Project rationale
The rationale behind the establishment of the private equity funds was to create economic value in an environment of substantial corporate restructuring and privatisation through investment in and management support of emerging private companies. It was anticipated that the funds would invest in domestic private companies that had potential for growth with particular emphasis on small and medium-sized privatisations or restructurings and joint ventures with foreign partners.

Achievement of objectives

Objectives at approval of fund A

- **Increase the level of foreign investment in the country (Achieved):** The Bank contributed about 18 per cent of subscribed capital to the fund. Other contributions were provided by private Western investors. The Bank's participation signalled to foreign investors that the deficiencies in the market were capable of being overcome and thereby helped to increase the level of foreign investment in the country.

- **Deepen the national equity market (Achieved):** The fund invested in over 20 companies. The fund's success in structuring a number of exits in the form of initial public offerings (IPOs) or trade sales through the stock exchange contributed to the growth in capitalisation of the market. Approximately 30 per cent of all the investments were exited via the public market, while a number of exits were by way of stock exchange trade sales.

- **Facilitate access by private and privatising companies to needed equity finance, particularly enterprises undergoing privatisation (Partly Achieved)**

- **Extend the operations of a successful fund management team (Achieved):** Significant improvements were made by the fund manager over time in monitoring and reporting portfolio performance. The fund manager built a successful track record in investment performance with a proficient fund management team.

Objectives at approval of fund B

- **Deepen the national and regional equity markets (Partly Achieved):** The objective was achieved at the national level.

- **Extend the operations of a successful private equity fund management team (Achieved)**

- **Facilitate access by domestic and regional private and privatising companies to needed equity finance (Achieved):** Regional investments amounted to a significant proportion of the portfolio and supported the private development of a major industry sector.

- **Attract foreign investment to central Europe (Achieved):** In addition to a number of contributions from foreign limited partners the fund attracted the first investment in the region by a large retirement fund.

Overall assessment

A key objective of the funds was to help build an efficient national capital market by making capital available and assisting the fund manager to develop capital market skills through which to add further value to portfolio companies. The funds succeeded in achieving these objectives but were less successful in meeting more detailed ex-ante expectations relating to regional expansion and furtherance of the privatisation programme. Financial performance was mixed.

The financial performance of fund A was affected by adverse economic conditions so that the return actually achieved may be considered reasonable in the circumstances. Fund B produced higher returns. On the basis of its independent assessment, the evaluation team assigns an overall performance rating of "Successful" to the funds under review. The funds have achieved strong realised transition impact at several levels and the potential for remaining transition impact is also strong.

The fund manager has built an experienced team with capacity in deal origination and portfolio management, including monitoring and reporting. The fund manager has developed skills in selling on portfolio companies through the market or to strategic investors or trade buyers at good prices. This has contributed to the development of the national capital market. Through effective supervision and skills transfer the fund manager has assisted portfolio companies to increase managerial capacity and improve governance, thus further adding value to investments.

Taking these various factors into account, transition impact is rated "Excellent". The environmental performance of the fund manager has been impressive. The Bank's additionality is "Verified at Large". The Bank's investment in successive funds helped ensure the flow of equity capital to the market and attract funds from new foreign investors.

Transition impact and additionality

Overall transition impact
For the reasons given above, the evaluation team considers that the funds warrant a realised transition impact rating of "Excellent" with "Excellent" potential and "Low" risk to achieving that potential. The "Low" risk rating should be seen as a reflection of the funds' success in building on an earlier track record and maintaining the momentum of growth with strong demonstration effects.

Company impact
The funds under review were built on the successful track record of two earlier private equity funds. The fund manager grew to be one of the most significant private equity players in the region and is seen to have paid due attention to the staffing needs of investment selection, due diligence, monitoring and hands-on guidance of investee companies when required.

Industry impact
The fund manager developed significant market placement skills which created scope for taking an active role in the equities market, providing improved opportunities for exit and expanding market activity by promoting the market through placements.

Impact on the economy as a whole

A key element of the fund manager's approach was the hands-on assistance given to companies with the implementation of strategic plans, financial systems and sales and marketing programmes. This had an impact on individual investee companies and on the economy more broadly via demonstration effect Where appropriate, the fund manager also played a role in helping companies identify opportunities to form strategic alliances. Attention should also be drawn to the role of the funds as a catalyst for investment during economic downturns. The geographical diversity of investments is also relevant to the assessment of the effect on the economy as a whole. A majority of investee companies are located outside the national capital.

Environmental impact

In recent years the fund manager has hired a local environmental consulting firm to undertake an annual environmental review of portfolio companies and report on environmental performance. The most recent report comments on such matters as occupational health and safety, fire safety, wastewater management and air pollution. It also identifies some issues of non-compliance with standards which are being addressed. The evaluation team assigns a rating of "Good" for environmental performance and a rating of "Substantial" for extent of environmental change.

Bank handling

The evaluation team considers that the fund manager's performance is due, in no small degree, to guidance given by the European Bank for Reconstruction and Development's (EBRD) operation team, especially during the early years of the relationship. The favourable impact of the Bank's guidance is observable principally in three areas:

- realistic valuation of portfolio companies
- improved portfolio analysis and reporting
- environmental performance.

Moreover, the EBRD remained supportive of the fund manager during currency fluctuations and the general fall in the stock market, underlining the importance of the Bank's strategic role. The evaluation team assigns a rating of "Good" to Bank handling.

Key issues and lessons learned

Key success factors

The evaluation has identified a number of factors that can contribute to favourable outcomes for Bank interventions in the development of capital markets through participation in equity funds.

Lessons: Creating an enabling environment for private equity

- Strong initial covenants with the fund manager and other limited partners can protect the Bank's financial interests and transition goals while helping to cement the relationships. Covenants can be amended as appropriate as the Bank's confidence in counterparties grows.

- Developed markets tend to feature an adequate legal framework and sound institutions that underpin the relationship between investors, fund managers and investee companies. Where the legal framework and institutions are weak, compensating features should be built into project design to ensure fund managers are able to prevent self-dealing by insider managers. For example, shareholder agreements with investee company owner-managers may include a put mechanism or guaranteed returns.

- Fund performance is likely to be enhanced and opportunities for successful exit increased if simultaneous efforts are being made to develop a well functioning capital market locally. Positive legal and institutional developments also help to increase investor confidence and expand the market. The Bank should continue to engage in policy dialogue and legal transition initiatives as necessary to encourage capital market development.

- Care should be taken when structuring funds on a regional basis. While it may appear that a regional fund intended to cover several sovereign states may thereby be able to target a larger market, it may not be appropriate to treat countries within a geographical region as a homogeneous block unless there is a good degree of convergence among them in law, regulation and practice.

- Consistent guidance and active EBRD support can enhance fund manager performance. The Bank should ensure it has strong representation on relevant decision-making bodies. These may include the Investment Committee, Advisory Committee, Supervisory Board or other bodies depending on the constitution of the fund manager. Where necessary, the Bank should encourage the fund manager to improve monitoring and reporting capacity over time. This should, in turn, enhance the fund manager's reputation and standing with other investors.

- Fund managers must have a practical and hands-on approach to dealing with investments that are not performing well. Fund managers must be proactive in encouraging portfolio companies to hire suitably experienced skills when needed to improve the management skills set.

- The capacity for active fund management is crucial when investee companies suffer distress in order to maximise potential value and the eventual return on exit. Fund managers must have the ability and capacity to restructure investments when necessary to minimise losses or improve opportunities for profitable exit.

- Fund managers must be prepared to enhance their own skills set when necessary by bringing in industrial management skills through hiring staff or consultants with industrial experience to augment the financially oriented experience of core staff.

- Fund managers need sufficient capital at their disposal to build critical mass and achieve economies of scale. Resources must be sufficient to build a management team with the necessary skills and maintain investment pace.

- Deal flow is critical to equity fund performance. It is appropriate for the Bank to consider providing finance to successor funds (subject to the additionality constraint) in order to support ingoing deal flow.

The need for the Bank to apply a coherent and consistent SME definition

Recommendation: Where operations are intended to target the small and medium-sized enterprise (SME) sector or achieve social impacts such as increased employment, measures for data collection, monitoring and reporting should be incorporated in the design of the operation. The Bank should adopt the European Union (EU) definition of micro, small and medium-sized enterprises to enable impacts to be recorded and reported in a consistent manner. This would enable performance to be measured against ex-ante objectives and targets. Where social effects such as employment impact are intended, effective monitoring and reporting procedures should be built into the operation at the design stage.