Operation Evaluation

Summary

Water utility (regional)

(A private sector investment operation)

June 2011

Evaluation Department (EvD)

European Bank
for Reconstruction and Development

The project

The Bank approved an equity investment to foster the private sector role in providing water and wastewater services in Russia and Ukraine. The facility consisted of a subscription of newly issued shares in the Company, representing 10 per cent of the Company's capital and voting rights on a fully diluted basis. At the time of writing, only part of the investment had been disbursed, and based on the Company's results, the first performance earn-out was not payable and it is expected that the second earn-out will not be payable either.

The Project evolved over three phases, which (in aggregate) constitute a substantial change to the original investment concept:

1. The proceeds of the initial investment were expected to provide funding for up to 57 per cent of the Company's development pipeline; in the event of this being exceeded, it was anticipated that the Company would fund any additional investments through a mixture of debt, internally generated funds and additional equity.

   It was envisioned that the transaction would contribute to privatisation of publicly owned entities and expansion of contracted-out services to the private sector. Also, it was expected that the Company would demonstrate high standards of corporate business conduct and foster the development of modern management, financial and operations skills in an expanding workforce across the region.

2. The original transaction did not proceed as expected and the Bank approved an extension facility of additional shares in anticipation of a landmark acquisition by the Client.

3. At the time of the evaluation field visit, neither the primary nor secondary rationales for the extension had materialised or substantially progressed. The originally envisaged acquisition candidate has so far declined to enter into acquisition talks with the Client. However, the Client subsequently separately acquired operational control of a different entity (another earlier Bank investment); it was then awarded the operational take-over of an additional entity and it is in pre-tender discussions for a public-private partnership (PPP) of other water facilities.

Table: Ratings summary

Overall assessment	♦♦◊◊	Partly successful
Transition impact	●●●●○○	Satisfactory
Achievement of objectives	●●●○○○	Marginal
Additionality	■■□□	Partly verified
Investment performance	●●●●○○	Satisfactory
Bank handling	●●●●○○	Satisfactory
Environmental and social impact	N/A	

Overall assessment

♦♦◊◊ Partly successful

EvD's overall assessment is *"Partly successful"* but with a negative bias.

Effectiveness

Achievement of objectives ●●●○○○ Marginal

- Phase 1 – partially achieved
- Phase 2 – not achieved to date
- Phase 3 – progress made but, except for a take-over and the very recent winning of a "showcase" tender, further genuine new market penetration results (to date) remain uncertain and behind initial appraisal expectations.

Hence, this evaluation arrives at a rating of *"Marginal"*. However, this rating should be interpreted in the light of the 2008-09 global financial crisis marked by worldwide falls in asset values, drying up of financing opportunities, and resultant postponements of investment decisions by municipalities. It is also acknowledged that the late success in obtaining concession agreements points to a possible success story, if further acquisitions follow.

Investment performance ●●●●○○ Satisfactory

The projected profitability for the Bank (combining both equity injections) led to an *ex ante* rating of *"Excellent"*. The Evaluation team could not ascertain how realistic this projection is.

Efficiency

Bank handling ●●●●○○ Satisfactory

The Bank's due diligence and monitoring work has met expectations; Bank handling is *"Satisfactory"*.

Impact/sustainability

Overall transition impact ●●●●○○ Satisfactory

At appraisal the investment was rated *"Good/Excellent"*, anticipating that the project would encourage increased private sector investments in municipal services (that is, PPPs). It was hoped this would bring more reliable and better services to citizens. The risk to transition impact was attributed to the lack of a track record in Ukraine and Russia and to the uncertain regulatory environment and authorities' commitment to reform.

The Office of the Chief Economist's (OCE) latest Transition Impact Monitoring System (TIMS) report notes that the objective of "more widespread private ownership and entrepreneurship" was not achieved, nor was utilisation of "competitive tenders or procurement procedures" attached to the envisaged Company acquisitions. Because of the lack of acquisitions, the "achieving of ISO9001 certificate" is at risk.

Transition impact monitoring, therefore, sees a downgraded transition impact potential rating from *"Good"* to *"Satisfactory"* with *"High"* risk attached.

Environmental and social impact N/A

The Project was screened C/1 and the potential for environmental improvement is high. But given that there is only one true acquisition, and this is still at a very early stage, the environmental impact cannot be rated at this point.

Findings and recommendations

Issue: Dual responsibility situation

Occasionally, the Bank's mandate and investment activities require it to take multiple positions as part of a single transaction, inevitably raising issues regarding their compatibility. The Bank as an investor promotes individual projects, and by necessity has specific vested interests at the company level. Simultaneously, however, the Bank frequently pursues wider objectives and interests at sector and policy levels (for example, through policy advice with commercial implications).

Whether the Bank can credibly act simultaneously at both levels, particularly where the Bank's investee company is intended to serve as a "wholesale" vehicle, is a genuine concern. This is even more of an issue where a member of the Bank's senior management (who supervises Bank intervention instruments such as loan, equity, TC, policy dialogue) assumes a board position on behalf of the Bank in an investee company.

Assuming a role as "honest broker" to promote municipal sector reform processes and advise on PPP tender structuring, and at the same time taking an equity stake in a vested player seeking to penetrate exactly the sector to which "independent" advice is given, requires both effectiveness of the "Chinese Wall" between both interest spheres and a solid perception of that effectiveness. This demarcation line became blurred when the responsible Business Director assumed the role as the Bank's shareholder representative in the investee company.

Lesson

The Bank should generally avoid placing its own staff on investee company boards, particularly where such investee companies are meant to act as a wholesale vehicle for the Bank. Independence of the adviser, both actual and perceived, is at the core of an "honest broker" function. It should not be compromised by Bank staff assuming board memberships in such strategic entities. Independence must also be judged from the perspective of (potential) external perceptions in order to protect the Bank's integrity and reputation.

Issue: Market distortion potential

If the Bank enters into a form of strategic alliance through an equity investment in a company that is a market leader in its field, care must be taken of the potential implications for the relevant investee markets. In this case it is possible that the competition the Bank is seeking to strengthen has been or could be reduced. The Bank's equity stake in the Client is financing the acquisition of two entities in which the Bank invested earlier, citing similar justifications as its investment in the Client. The relevant market is confined to about six to eight players. The said acquisitions will reduce this number even further (that is, given the market power commanded by the Client).

Also, the Company's intention to team up with others to win tenders becomes critical if it leads to concentration and anti-competitive behaviour. Outside observers have expressed concern that the Bank's alliance with the Client could actually undermine the intended aim of broadening competition. In a similar vein, the Bank needs to be wary that said strategic alliance does not discourage other potential providers from entering the market.

Lesson

The Bank's due diligence processes and transactions strategy should both be and appear to be robust to avoid any perception that the choice of investee concession partners is limited to favoured "pre-selected" candidates. One way to do this may consist of open tenders for municipal and environmental infrastructure "cluster" operations whereby the Bank would internationally invite expressions of interest for potential municipal and environmental infrastructure financing in a pre-determined Bank region, and guarantee to finance winning tenders and to provide political comfort, thereby facilitating competition.

Issue: Choice of instrument

There is an underlying question about whether equity or debt financing is better suited to the strategic aim of market penetration or expansion – upfront disbursement (through equity stake) or a more staggered disbursement approach linked to actual achievements and progress.

This question gains salience when each of the envisioned acquisitions constitutes an unrelated sub-project, where one could reasonably assume that the Company would opt for a sequential acquisition approach. The ultimate motive for adopting the equity route in the case at stake remains unclear from a project perspective. From an administrative and volume perspective, upfront disbursements may be seen as preferable.

It is true that, had the Bank opted for loan financing and even made disbursements contingent upon progress on acquisitions, it would possibly not have disbursed as much, if any, of the proceeds so far. These resources could have been used for alternative investments or treasury operations with lesser opportunity costs in terms of foregone benefits.

Lesson

Pre-funding by the Bank of expansion schemes (for example, *qua* equity stakes in wholesale structures) without early exit options (if the project does not develop as anticipated) deserves careful reflection. The investment programmes of Bank investment candidates might benefit from deeper scrutiny, including in some cases independent professional expertise. Bank income from dividend payments and penalty charges should not serve as compensatory justification. The related foregone project benefits need to be juxtaposed with the next best investment alternative in this respect.

Issue: Project recycling

Both of the identified acquisitions received previous investments from the Bank. They both constitute wholesale vehicles for the EBRD's Municipal and Environmental Infrastructure (MEI) department to reach out more quickly and widely, and possibly at lower cost per sub-investee than it could achieve through individually approaching municipalities. A strong case for buying out earlier investee companies would be expected to demonstrate a very substantial incremental transition impact attached to such investment. In the Evaluation department's (EvD) view, this has not been convincingly demonstrated.

Lesson

If an operation results in the buy out of entities in which the Bank has invested previously, there should be an expectation of particularly intensive due diligence results in a compelling demonstration of prospective benefits.

Report prepared by:
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General
●●●●●● Excellent
●●●●●○ Good
●●●●○○ Satisfactory
●●●○○○ Marginal
●●○○○○ Unsatisfactory
●○○○○○ Highly unsatisfactory

Extent of environmental change
✱✱✱✱ Outstanding
✱✱✱✳ Substantial
✱✱✳✳ Some
✱✳✳✳ None/Negative

Overall performance
♦♦♦♦ Highly successful
♦♦♦◊ Successful
♦♦◊◊ Partly successful
♦◊◊◊ Unsuccessful

Additionality
■■■■ Fully verified
■■■□ Mostly verified
■■□□ Partly verified
■□□□ Not verified