Background

Since its founding in 1991, the European Bank for Reconstruction and Development (EBRD) has used equity investments as a way to catalyse co-investments and realise improvements in firm-level performance – both of which are approaches that the Bank uses to achieve its goal of transformative impact.

The EBRD’s equity investments – money invested in a firm’s common stock, which is recovered only when the shareholdings are sold or when the firm’s assets are liquidated and the proceeds distributed\(^1\) – increased greatly in the years after the global financial crisis (2007-08). During this time, the competitiveness of the EBRD’s debt was declining, and there was a lack of equity in its countries of operations – meaning the demand was there for such investments. In 2013, an EBRD report argued for the greater use of instruments such as equity, in order to pursue the Bank’s institutional objectives.\(^2\)

Despite the many arguments in favour of pursuing this approach, the EBRD’s returns on its equity investments have been low, and the Bank’s current equity portfolio raises several concerns. For example, direct equity investments made between 2005 and 2014 returned 0 per cent, while the internal rate of return for vintages for 2014-16 has seen losses.

Over the years, the EBRD Management has introduced several initiatives to strengthen the Bank’s equity performance. These include the Enhanced Equity Approach, which was intended to elevate the strategic profile of equity within the EBRD and to improve the performance of the equity portfolio.

In 2017, the EBRD Evaluations Department reviewed the Bank’s equity portfolio approach, analysing the impact of the initiatives to improve equity performance and developments between 2005 and 2016. This review identified several significant issues regarding the Bank’s equity performance and approach, and made several recommendations for the Board and Management to consider. This summary brief presents these findings and recommendations.

Major findings

**Strategy for equity investments**

The EBRD’s equity investments are limited to minority interests only, due to concerns about conflicts of interest in managing related policy and debt interests. Beyond this, there are few policy constraints on the use of equity.

The Enhanced Equity Approach for direct equity, issued in 2016, brought a more focused and consolidated approach to equity. For example, it made important changes to the EBRD organisational structure to improve project design and portfolio management and establish a culture of value creation. But while this new approach touches on many of the key issues with equity performance, it does not provide the level of clarity needed given the scope and scale of the challenges, or provide a basis for improving performance in the future.

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1 See: [www.businessdictionary.com/definition/equity-investment.html](http://www.businessdictionary.com/definition/equity-investment.html)
Structure of the equity portfolio

At the time of the evaluation review, the two main components of the EBRD equity portfolio were: (a) direct equity (210 investments, accounting for 76 per cent of the portfolio by cost), mainly in medium to large companies, with global and local strategic investors and other financial institutions; and (b) private equity funds (122 investments, 24 per cent), primarily orientated to support the private equity fund industry and deploy equity to firms.

In terms of sectors, the portfolio was primarily focused on financial institutions, with limited exposure to infrastructure. But significantly, the direct equity portfolio was unbalanced, with a large number of small investments coupled with a small set of very large exposures; 34 per cent of the portfolio by value was allocated to projects exceeding €100 million in size.

Organisational arrangements for equity operations

Due to the deteriorating financial performance of the EBRD’s equity operations since 2004, the Enhanced Equity Approach recommended changes in the way that the Bank managed its equity investments. Overall, these would increase the EBRD Equity Group’s control over the portfolio.

Despite these suggestions, the division of duties and responsibilities between the Equity team and the Banking Department remains partial. For example, equity investments made under the Direct Financing Facility are still managed by Banking under the supervision of the Small Business Investment Committee, rather than the Equity team that normally approves equity projects; this reduces clarity about responsibility for managing the equity portfolio and what is meant to be achieved.

More widely, the EBRD lacks sufficient staff with skills in equity and the aligned incentives needed to make the best use of its capital to support transition impact and financial performance. The EBRD’s levels of equity staff are no more than 50 per cent of industry norms, and reporting arrangements to the Board are poor.

Portfolio performance

In many respects, the EBRD’s equity portfolio has performed below expectations:

- Direct equity generated a 0 per cent return on vintages from 2005 to 2014.
- The internal rate of return for vintages was –2 per cent in 2014, –10 per cent in 2015, and –12 per cent in 2016.

The evaluation review noted particular concerns about the large number of non-performing minority direct equity investments. Overall, private equity funds consistently outperformed direct equity investments by about 3 per cent per annum; this amount would increase if the EBRD management costs were taken into account.
Recommendations

The Evaluations Department made the following suggestions for improving the EBRD’s equity performance.

1. **Clarify institutional and resourcing arrangements for developing and managing the equity portfolio.** For example, the Equity Group should have unambiguous authority to manage all equity investments and approve new equity investments.

2. **Prepare an independent external review of the existing portfolio, staff resources and operations.** This will help with efforts to restructure the EBRD equity portfolio, by identifying redundant investments that no longer contribute to transformative impact objectives.

3. **Prepare an independent review of alternative institutional arrangements to manage the EBRD equity portfolio.** These alternatives might include ring-fencing equity as a separate part of the Equity Group, or fully separating equity as a subsidiary.

4. **Prepare an equity strategy for review and approval by the Board.** This should include: (a) clear objectives for the portfolio; (b) details on how market opportunities will be developed and integrated into country strategy programmes; (c) details on how the portfolio will be structured; and (d) a full set of financial statements and reports on the equity portfolio, to be provided on a regular basis.
The Evaluation Department (EvD) at the European Bank for Reconstruction and Development (EBRD) reports directly to the Board of Directors, and is independent from the Bank’s Management. This independence ensures that EvD can perform two critical functions: reinforcing institutional accountability for the achievement of results; and providing objective analysis and relevant findings to inform operational choices and improve performance over time. The Department evaluates the performance of the Bank’s completed projects and programmes relative to objectives.

This summary has been prepared by EvD under the authority of the Chief Evaluator. The views expressed herein do not necessarily reflect those of the EBRD’s Management or its Board of Directors. Responsible members of the relevant operations teams were invited to comment on the study prior to internal publication. Any comments received will have been considered and incorporated at the discretion of EvD. While EvD considers Management’s views in preparing its evaluations, it makes the final decisions about the content of its reports. The study was discussed by the EBRD’s Audit Committee and approved by the Board.

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