

# EQUITY OPERATIONS

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July 2017

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**European Bank**  
for Reconstruction and Development

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This Special Study was prepared by Bob Finlayson, Associate Director, Senior Evaluation Manager, and approved by Joe Eichenberger, Chief Evaluator.

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EVALUATION DEPARTMENT SPECIAL STUDY

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## Abbreviations

<b>CEB</b>	central Europe and the Balkans
<b>DSF</b>	donor-supported fund
<b>EBRD</b>	European Bank for Reconstruction and Development
<b>EPF</b>	Equity Participation Fund
<b>EPMU</b>	Equity Portfolio Monitoring Unit
<b>ERUS</b>	Russian stock market
<b>EU</b>	European Union
<b>EvD</b>	Evaluation Department
<b>FI</b>	financial institution
<b>GDP</b>	gross domestic product
<b>GP</b>	general partner
<b>ICT</b>	information and communication technology
<b>IFC</b>	International Finance Corporation
<b>IFI</b>	international financial institution
<b>IFRS</b>	International Financial Reporting Standards
<b>IPO</b>	initial public offer
<b>IRR</b>	internal rate of return
<b>LC2</b>	Local Currency and Capital Market Initiative
<b>NCBI</b>	net cumulative bank investment
<b>pa</b>	per annum
<b>PEF</b>	private equity fund
<b>RUB</b>	Russian rouble
<b>SME</b>	small and medium-sized enterprise
<b>US\$</b>	US dollar



# Executive summary

Since its founding, the European Bank for Reconstruction and Development (EBRD) has used equity investments to catalyse co-investment and improvements in firm-level performance, in order to contribute to wider transition impact. Equity holdings – both direct and in private equity funds – accounted for 15-20 per cent of the EBRD's portfolio from 2005 to 2016.

Equity has received both greater attention and greater scrutiny in recent years. Investment levels were ramped up after the global financial crisis, in line with an increase in lending. The Stuck in Transition report (EBRD, 2013a) argued for greater use of instruments, such as equity, to pursue institutional objectives. Declines in the competitiveness of the EBRD debt post-crisis, and a lack of equity in countries of operations, reinforced this view.

At the same time, equity returns have been low and deteriorating, and the EBRD's current portfolio presents numerous concerns. At the end of 2016, the active equity portfolio's investment cost was €6.0 billion, compared with a fair value of €5.5 billion, and it accounted for about 20 per cent of the EBRD's total portfolio of €29.7 billion. Direct equity, accounting for 76 per cent of the equity portfolio, returned 0 per cent on investments made between 2005 and 2014; the internal rate of return (IRR) for the vintages for 2014-16 has become increasingly negative, accompanied by large, unrealised losses.

The EBRD Management has intensified its focus on its equity business in recent years, introducing several initiatives to strengthen performance. The Institutional Investment Partnership was established in 2013 as a mechanism for the EBRD to partner with institutional investors; this was intended to attract large long-term institutional investors, such as sovereign wealth funds. An equity participation fund, the first of an anticipated series of institutional investment partnership co-investment funds, achieved its first closing in September 2016 having raised €350 million from two sovereign wealth funds. And earlier in 2017, the Management presented the Enhanced Equity Approach, intended to elevate the strategic profile of equity and set out broad directions for better performance and value creation.

This evaluation focuses on the Bank's equity portfolio approach and developments between 2005 and 2016. It identifies significant and difficult issues regarding performance and approach and, on the basis of these findings, makes several recommendations for consideration by the Board and Management.

## Main findings

### Strategy

- The Bank's Agreement Establishing the EBRD, (EBRD, 2013b: Article 12) limits the EBRD's equity 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.
- Following the global financial crisis, equity was an important instrument for recapitalising banks. By comparison, investments in infrastructure (i.e. energy, transport, and municipal and environmental infrastructure), industry, commerce and agribusiness appear to have been scaled back – with no compensating shift to equity.
- The Transition Report (EBRD, 2016a) showed the level of investment in equity is a function of several factors, including macroeconomic stability and the quality of the institutional environment; the latter dominates in countries of operations, given divergent levels of regional investment post-crisis.
- The Enhanced Equity Approach for direct equity, issued in early 2016, introduced important changes to the EBRD's organisational structure, to improve project design and portfolio management, and establish a culture of value creation.
- With the Enhanced Equity Approach, the Management acknowledged the need for a more focused and consolidated approach to equity. But while the Enhanced Equity Approach has several appropriate elements and touches on many key issues, it does not provide the level of clarity needed, given the scope and scale of the challenges, or provide a basis for sustainable improvements in performance moving forward.

### Structure of the equity portfolio

- The two main components of the equity portfolio are: (a) direct equity (210 investments,



accounting for 76 per cent of the equity portfolio); and (b) private equity funds (122 investments, accounting for 24 per cent of the portfolio by cost).

- The main market for direct equity investments has been medium to large companies, with global and local strategic investors and other financial institutions. A primary driver of initial growth in this market was the privatisations of the 1990s and early 2000s. The approach to private equity funds (PEFs) is very broad, but is primarily oriented to support the PEF industry and to deploy equity to firms.
- The PEF portfolio is small in the context of the EBRD's overall operations, although the Bank is the largest limited partner in PEFs in central and south-eastern Europe, and the Commonwealth.
- Equity investments in the financial sector were ramped up during the financial crisis, but otherwise operations were fairly constant. Russia and, in recent years, Cyprus, Greece and Turkey have dominated the portfolio by region; high levels of geographic concentration have brought vulnerability to macroeconomic shocks.
- The portfolio was primarily focused on financial institutions, with limited exposure to infrastructure. The direct equity portfolio is unbalanced: there is a large number of small investments, coupled with a small set of very large exposures; 34 per cent of the portfolio by value is allocated to projects exceeding €100 million in size. Some investments exceed 20 years; 27 per cent of the portfolio by fair value exceeds the target life of 7-8 years.

### **Organisational arrangements, resources and skills**

- Due to deteriorating financial performance, starting from 2004, the Enhanced Equity Approach identified changes in the way equity was to be managed, intending to increase the Equity Group's control over the portfolio, from origination to exit.
- Despite the Enhanced Equity Approach, the split between the Equity team and Banking is partial. Banking remains responsible for origination, although its incentives are based on volume, rather than quality, of investment. Direct Financing Facility Equity investments are still managed

by Banking under the supervision of the Small Business Investment Committee, rather than the Equity Committee, which normally approves equity projects; this reduces clarity about responsibility for managing the equity portfolio and what is meant to be achieved.

- There is a lack of adequate EBRD staff with equity skills and aligned incentives to make the best use of capital to support transition impact and financial performance; levels of equity staff are no more than 50 per cent of industry norms, and reporting arrangements to the Board are poor.

### **Portfolio performance**

- Transition impacts for equity projects tend to be equated with financial performance or additionality; this potentially creates financial risks for the EBRD, given its limited ability to mitigate the macro-level and institutional risks through such projects.
- Direct equity generated a 0 per cent return on vintages from 2005 to 2014; the IRR for vintages in 2014 was -2 per cent; in 2015, -10 per cent; and in 2016, -12 per cent. The equity portfolio generated unrealised losses of €675 million in 2014, €748 million in 2015, and €468 million in 2016. Equity requires a return of 3.5 times debt to avoid opportunity costs on the use of EBRD capital. Data show that equity actual losses are large; opportunity costs have risen over time due to an increase in portfolio size and returns that are less than the equity's cost of capital.
- Portfolio performance is lowest in the southern and eastern Mediterranean, Russia and central Asia; this is mainly due to macroeconomic instability linked to exchange rate movements. Sector returns in 2016 indicate that despite large losses in Cyprus and Greece, financial institutions had an IRR of 3.5 per cent and energy sector returns recovered to 8.5 per cent – but infrastructure deteriorated further, to -15.3 per cent.
- There are concerns about the large number of non-performing minority direct equity investments. The EBRD has limited ability to add value or exit, and incentives for management to exit are weak, as this would crystallise losses – even if it would be a better use of capital.

- PEFs consistently outperform direct equity investments by about 3 per cent per annum; this amount would increase by a substantial margin if the EBRD management costs were taken into account.

## Recommendations

- Clarify institutional and resourcing arrangements for portfolio development and management. The Equity Group should have unambiguous authority to manage all equity investments, including the Direct Financing Facility regional investments, and approve new equity investments. Clarity is needed on how the Equity Group and Banking will be resourced for project preparation, management and divestment, and with respect to how departments and staff will be incentivised to manage equity.
- Prepare an independent external review of the existing portfolio, staff resources and operations, with a view to restructuring the portfolio by identifying redundant investments, and their associated resources, that are no longer contributing to transition impact objectives. This is also an opportunity to strengthen operations and reporting arrangements.
- Prepare an independent review of alternative institutional arrangements to manage the EBRD's equity portfolio, such as: (a) mixed debt and equity (status quo); (b) offering opt-out clauses to limited partners in the equity participation fund; (c) ring-fence equity as a separate part of the Equity Group, with dedicated staff, notional accounts and performance incentives; (d) fully separate equity as a subsidiary, following the model established by the International Finance Corporation's Asset Management Company that uses market-based carried interest incentives; and (e) take majority shareholdings in investee companies.
- Prepare an equity strategy for review and approval by the Board. It 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, given prudent diversification standards and efficient and effective use of equity capital; and (d) the content of a full set of financial statements and reports on the equity portfolio, to be provided on a regular basis to the Financial and Operations Committee and the Audit Committee, that are consistently accessible over time.



1

# Introduction

## 1.1. Rationale

The European Bank for Reconstruction and Development (EBRD) views equity investments as an important instrument to catalyse investment and transition towards open-market-orientated economies. Equity accounted for 15-20 per cent of the EBRD's portfolio from 2005 to 2016. Equity has been subject to increasing scrutiny in recent years. The findings of the Stuck in Transition report (EBRD, 2013a) suggested the Bank needed to make greater use of instruments such as equity to pursue development objectives. Declines in the competitiveness of EBRD debt after the global financial crisis, and a lack of equity in countries of operations, reinforced these views.

At the same time, returns from equity investments have been low and deteriorating. Direct equity accounts for the bulk of this portfolio. After generating 0 per cent returns on equity investments made from 2005 to 2014, internal rates of return (IRR) for the vintages for 2014-16 have become increasingly negative and were accompanied by large, unrealised losses. In response, the EBRD has introduced several initiatives to strengthen the performance of its equity operations. These include the new Enhanced Equity Approach, which was presented to the Board in April 2016.

The Evaluation Department (EvD) included a review of the Bank's equity portfolio in its Work Programme for 2017. This study, which covers the period 2005-16 (the evaluation period), is a desk-based review designed to contribute to the Board and the Management's consideration of opportunities to improve the Bank's equity operations at a time when they are under close review.<sup>1</sup> A summary of the EvD's preliminary findings was presented to the Finance and Operations Policies Committee prior to a meeting on 9 March 2017, at which the Committee received an update on the Enhanced Equity Approach. The EvD's preliminary findings identified opportunities to strengthen operations in the areas of: (a) the selection and management of equity investments; (b) the potential to use alternative types of instruments to catalyse investments; and (c) revising the institutional arrangements to manage equity. This Special Study elaborates on these preliminary findings and provides the EvD's fuller, underlying analysis of the EBRD's equity portfolio.

<sup>1</sup> This evaluation builds upon earlier EvD work, including the 2014 report, *Achieving Equity Investment Objectives: A Review Of Initiatives Since 2007* (EBRD, 2014a).

## 1.2. Objectives

The evaluation presented in this study was designed to answer the following questions:

- How was equity intended to contribute to improvements in outcomes of high transition impact importance, to both investee countries and the EBRD?
- Were investments and supporting institutional arrangements (e.g. management and staffing levels, information systems, budgeting, monitoring and reporting arrangements) sufficient to achieve the stated objectives?
- What accomplishments can be identified from the EBRD's equity investments in terms of achieving transition impact objectives?
- Does experience suggest ways in which the effectiveness and efficiency of equity investments might be improved?

## 1.3. Evaluation challenges and limitations

The EBRD has been using equity instruments since it was founded in the early 1990s. Consequently, there is a large amount of data that can be drawn upon to measure transition impact and financial performance. In practice, however, the quality of the data is often poor, due to certain characteristics of equity. For example, it is difficult to measure equity performance, as investments have long 'lives'. Further, the portfolio relies on 'fair values', where assumptions, particularly on expected exits, are difficult to verify – limiting the availability of reliable feedback on performance within a useful time frame.<sup>2</sup> Another issue is that it is impossible to hedge currency values of equity and its value is derived in local currency terms. Meanwhile, intermittent periods of extreme market volatility, and complex underlying investment structures for equity investments, have compounded the difficulties experienced in interpreting the data. There are often

<sup>2</sup> Fair value is defined under International Financial Reporting Standards (IFRS) as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date". Under IFRS, fair values are based on a combination of market multiples, discounted cash flows and net realisable asset values. Ernst and Young (2012) noted that "until recently there was limited guidance in IFRS on how to measure fair value and, in some cases, the guidance was conflicting".

delays of several years before the publication of data that can be used for trend analysis.

There are also concerns about the adequacy of the structure and content of equity reports reviewed by the Board. These reports have tended to focus on private equity funds (PEFs), which accounted for a small proportion (about 24 per cent) of the equity portfolio. In many cases, transition impacts for equity investments were not directly defined, but were conflated with financial performance. While there are data available on financial returns from equity investments that have been exited, the lack of specific transition impact objectives and defined exit strategies makes it difficult to determine what was achieved, or to compare actual versus expected performance, to provide lessons for the future.

There is no set of financial statements for equity investments and associated EBRD resources, and this creates significant problems in assessing changes in the size and composition of the equity portfolio and underlying profitability. Under the current institutional

arrangements, there is a risk that successful projects are exited and reported early, whereas less successful projects remain active and largely unreported, creating an upward bias in reported results. The magnitude of this bias is compounded by confidentiality provisions for investments and the establishment of an in-house fund, the Equity Participation Fund, which is seeking to attract external funds, thus creating incentives to limit information flows. Archiving procedures for reports are not defined, and the Equity Portfolio Performance reports made available to Board members are subject to varying levels of access restrictions. There is a consequent lack of clarity on the status of documents, when they are uploaded, and even which documents to ask for, when reviewing past performance.

To the extent possible, the EvD has drawn upon the experience of other international financial institutions (IFIs) to help draw conclusions on key drivers of the performance of the EBRD equity portfolio, and identify opportunities for improvements in effectiveness and efficiency.



# 2

## The EBRD's equity portfolio

## Key facts and findings

- The EBRD uses a mixed management structure that combines debt and equity operations within a single institutional framework.
- To avoid conflicts of interest with policy and debt operations, the EBRD will take only minority positions in companies and PEFs.
- Direct equity investments have dominated the portfolio (about 80 per cent), but they have not been a prominent aspect of reported operations. They have mainly been treated as an input to projects, rather than a distinctive class of asset.
- In 2013, the EBRD established the Institutional Investment Partnership as a mechanism to partner with institutional investors. In 2016, the Equity Participation Fund issued the first of a series of anticipated co-investment funds of the Institutional Investment Partnership; this was designed to attract large, long-term institutional investors, such as sovereign wealth funds, to invest in equity in countries of operations by offering a fixed share of all EBRD equity investments over €10 million.
- Management has plans to increase the performance of the equity operations substantially. One initiative to achieve this is the Enhanced Equity Approach, introduced in 2016.
- The EvD's thematic evaluations generally present a positive view of the performance of equity, but it was noted as early as 2001 that the EBRD needed to strengthen its equity organisation structure and operations processes.
- PEFs have been the primary focus of equity evaluations in the past, particularly small, in-house development funds that experienced financial difficulties.

### 2.1. Overview

The EBRD makes equity investments (see Box 1) to catalyse public and private co-investment, and to support improvements in firm-level performance that are expected to contribute to transition impact. The most important policy principle and operational directive on the use of equity is defined in the Agreement Establishing the EBRD (EBRD, 2013b), which states that the EBRD is permitted to take only minority interests in a company's equity.<sup>3</sup> This principle was established due to concerns about potential conflicts of interest for the management of equity versus the EBRD's policy and debt interests. The EBRD can invest in the equity capital of private sector enterprises and state-owned enterprises operating competitively and moving to participation in a market-orientated economy. The EBRD can also invest in the equity capital of state-owned enterprises to facilitate transition to private ownership and control. The EBRD's policy

framework provides a few additional constraints on the use of equity (see Appendix 1).

The EBRD usually invests in 10-35 per cent of an investee's share capital, relying on board representation and minority investor rights in shareholder agreements to create transition impact and protect value. Within this framework, it pursues a mix of policy dialogue, technical cooperation and minority co-investments in equity instruments in countries of operations. The EBRD has provided extensive legal advice and technical cooperation to governments outside equity investments on issues such as company laws on shareholder protection, the enforceability of shareholder agreements, minority shareholder rights and the auditing of accounts.

Equity has featured prominently in the EBRD's operations since the early 1990s, with investments made across most sectors and countries of operations. After the financial crisis, the volume was ramped up alongside increased lending. As of 31 December 2016, the active equity portfolio's investment cost was €6.0 billion

<sup>3</sup> The Agreement Establishing the European Bank for Reconstruction and Development (EBRD, 1990) was signed in Paris on 29 May 1990 and came into force on 28 March 1991.

## Box 1. Equity finance

Equity provides a firm with perpetual long-term capital that does not receive a guaranteed return on investment. In exchange for equity, capital shareholders have claims to the residual cash flows of the business in proportion to the amount of equity capital provided to the firm, and control of management through voting rights to elect members of the board of directors. If equity shareholders wish to exit, they must sell their shares to a third party.

By comparison, debt provides a temporary source of capital, with a defined return but no management decision rights. In exchange for debt capital, the borrower firm usually provides lenders with an amortising capital exposure by repaying the loan back over time, providing asset-backed collateral, and providing loan covenants to help mitigate financing risks.

compared with a fair value of €5.5 billion. At this time, total equity and equity commitments comprised about 20 per cent of the EBRD's total portfolio of €29.7 billion. The two main components of the equity portfolio were:

1. Direct equity, consisting of 210 investments that generated a reported IRR of 3.5 per cent, based on a portfolio with an investment cost of €4.7 billion, which represented 77 per cent of the equity portfolio by cost.
2. PEFs, consisting of 122 investments that generated a reported IRR of 4.6 per cent, based on a portfolio with an investment cost of €1.4 billion, which represented 23 per cent of the equity portfolio by cost.

## 2.2. Portfolio components

### 2.2.1 Direct equity co-investments

An important feature of direct equity is the EBRD's ability to decide when it wishes to exit, and it has a policy of linking exits to the achievement of transition impact objectives. The EBRD's direct equity portfolio includes pure equity and structured equity, which has debt-like provisions attached to equity contracts, such as put options (an option to sell assets at an agreed price on or before a particular date) to facilitate exit. In some cases, call options are used to create an incentive

for the incumbent strategic shareholder to buy out the EBRD's interest. The EBRD's direct equity investments target small, local investors through in-house funds, and medium to large strategic investors through company-specific finance. In recent years, the annual volume of direct equity investments has ranged from €600 million in 2014 to €1.1 billion in 2015, before declining to €400 million in 2016. Management expects to hold these investments for four to seven years.

### *Small local investees*

Following mass privatisations in countries of operations in the early 1990s, there was a rapid increase in the number of small and medium enterprises (SMEs). These lacked access to equity due to low levels of savings, and there were few foreign investors in these markets. The EBRD saw equity as being most important in the early stages of a firm's life, and direct investment funds financed by foreign investors were one of the few sources of equity capital available in these countries.

To help address this need, the EBRD established several funds from the early 1990s to the mid-2000s to provide a wholesale mechanism to channel funds rapidly to SMEs. These funds were managed by the regional departments and they were often supported with non-commercial donor funds for project preparation and development. The three primary SME funds in this category were the Direct Investment Facility, the EBRD-Italy financed Local Enterprise Facility, and the Private Equity Co-Investment Facility.

In 2011, the EBRD approved a dedicated framework facility of up to €100 million for the venture capital investment programme to co-invest alongside experienced venture capital investors in early- and growth-stage SMEs in the information and communications technology (ICT) sectors in countries of operations. The venture capital investment programme was jointly developed by the ICT and the Equity Funds sector teams, and it was envisaged that it would follow a portfolio approach, investing in companies with high risk and high returns.

Due to the risks attached to early-stage investments and the high costs of operations, these in-house funds for SMEs accounted for only a small proportion of the EBRD's direct equity operations. For example, the venture capital investment programme represented about 2 per cent of the equity portfolio at the time of approval. Due to their small size and large number of sub-investments, several of these funds, including



the Direct Investment Facility and Local Enterprise Facility, were merged into a Direct Financing Facility, and oversight responsibility was delegated to the Small Business Investment Committee (EBRD, 2015a).

### **Medium to large strategic investees**

The EBRD has co-invested equity in medium to large investee companies in its countries of operations with global and local strategic investors and other financial institutions. Direct investments have been made to medium and large enterprises in a wide range of sectors since the beginning of the EBRD's operations in 1992, and it is the main category of equity in its portfolio.

Similar to SMEs, a primary driver of the direct equity portfolio for medium to large firms was the privatisation programmes implemented through the 1990s and early 2000s. The EBRD often facilitated privatisation by participating in unlisted trade sales to large strategic investors, and listed initial public offers (IPOs) for firms trading on stock exchanges. As of December 2016, the direct equity portfolio comprised 43 listed investments, accounting for 41 per cent of direct equity fair value, of which 78 per cent was considered liquid – **indicating that less than 33 per cent of the direct equity portfolio was invested in freely tradable assets.**

In some cases, the EBRD's initial equity investments were complemented with follow-on financings of equity and loans to support restructuring and growth, particularly in sectors such as financing institutions that required capital for expansion, and telecoms companies seeking new technology. The EBRD managed these investments through shareholder agreements and nominee directors that it appointed to the boards of directors of investee companies. In 2016, direct investments were supported by about 155 nominee director positions that were held by 79 (51 per cent) internal staff and 76 (49 per cent) external appointees. External appointees were a mix of retired EBRD staff and country/sector specialists.

There has been a range of alternative means of exiting from direct equity investments. Management reported (EBRD, 2017a) that realised exits for direct equity as a percentage of original cost were as follows: sale to financial intermediary, 62 per cent; put and call, 22 per cent; market exit, 5 per cent; sale to shareholders/management and trade sale, 3 per cent. Many of these exits by number (about 55 per cent) were reported to be partial sales.

## **2.2.2 Private equity co-investments**

The EBRD started to take minority investments in PEFs (see Box 2) in the early 1990s, although at a much lower level than for direct equity. The EBRD differentiates between the following types of PEF: (a) equity (83 per cent of its PEF portfolio); and (b) property (17 per cent).

### **Box 2. Private equity funds**

PEFs provide an instrument by which specialist investment managers make equity-financed investments in all types of companies, through a partnership structure using share capital that is privately held rather than being publicly tradable. PEF investments differ from direct equity as the investments are time-bound, and the fund manager can take majority investments in investee companies. PEFs make small sub-investments in companies, and the size of the fund is scaled in accordance with investment objectives, which range from SME start-ups in high technology through to medium-to-large buy-out companies in mature industries (e.g. energy infrastructure).

PEFs provide strong governance and long-term financing to enterprises that can be used to introduce new technology and skills, and strengthen management practices. They can also take majority shareholding positions, which provide fund managers with the capacity to play a guiding role in the management of the investee companies.

A typical PEF structure is an 8-10 year partnership controlled by a general partner (GP), who acts as fund manager. Funding is provided by limited partners, who are passive investors. The PEF structure allows the GP/fund manager to focus on investing for a set time frame and draw down capital as required, without needing to return to investors for more capital. GPs have a strong incentive to minimise the amount of capital that is utilised, due to a cost-of-carry charge. The combination of majority ownership decision rights and carried interest charges provides GPs with the ability and incentives to create self-liquidating portfolios of investments. This arrangement balances the illiquid nature of unlisted equity sub-investments in portfolio companies with investors' desire for liquidity in their PEF investments in the medium term.

The EBRD's investments in PEFs totalled €223 million in 2015, falling to €187 million in 2016.

The PEF structure presented in Figure 1 is designed to create a long-term alignment of incentives between the GP and the limited partner. An annual management fee (usually 2 per cent of the fund's assets) is paid to the GP, as fund manager, to cover operating expenses. Carried interest provides a share of realised profits (usually 20 per cent) that is retained by the GP/fund manager, and is structured to be the largest component of their remuneration (typically about 75 per cent of the GP's remuneration).<sup>4</sup> GPs/fund managers are normally paid only after the return of investor capital, including management fees, and a return on capital. In this way, the carried interest provides a performance incentive in the form of a large personal investment in the fund by the GP/fund manager.

### The EBRD as a limited partner

The EBRD is the largest limited partner in PEFs in central and south-eastern Europe and the Commonwealth. PEFs have been split between commercial and donor-supported funds (DSFs). Similar to the donor-financed in-house equity funds, DSFs have gradually been overtaken in importance by commercial PEFs. Investments in PEFs have provided opportunities for co-investments in direct equity transactions. The EBRD always participates as a member of the PEF Limited Partner Advisory Committee, and in some cases it may act as an observer of the investment committee.

4 EvD estimate.

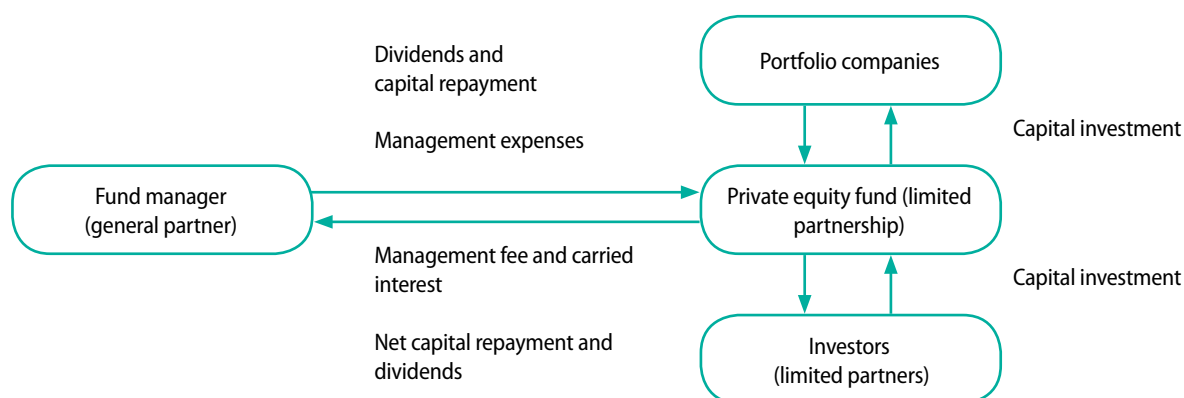
### The EBRD as a fund manager

In 2013, the EBRD established the Institutional Investment Partnership as a mechanism to partner with institutional investors. In 2016, the Equity Participation Fund issued the first of a series of anticipated co-investment funds of the Institutional Investment Partnership. This is designed to attract large, long-term institutional investors, such as sovereign wealth funds, to invest in equity in countries of operations. The Equity Participation Fund provides limited partners with a fixed proportion of 20 per cent, rising to 30 per cent for new Equity Participation Fund eligible investments made after the size of the Equity Participation Fund reaches €500 million or greater.

Projects follow EBRD procedures, control is retained by the EBRD, and fund participants cannot influence the EBRD's investment decisions. The EBRD retains ownership of the shares in the underlying investee companies, and the limited partners hold equity participation notes in the Equity Participation Fund. The EBRD provides limited partners with the option to exit through a liquidity redemption facility at the end of the fund's life, where asset values are based on fair value. This structure provides limited partners with the benefit of the EBRD's regional presence, strong governance arrangements and high investment standards that can be used to mitigate political and commercial risks (EBRD, 2015b).

The Limited Partner Advisory Board enables investors to engage with the EBRD, but it does not provide limited partners with any investor decision rights. The EBRD is the fund manager of the Equity Participation Fund, and management fees are based on market rates, although

**FIGURE 1. STRUCTURE OF THE PRIVATE EQUITY FUND**



there is no carried interest charged by the EBRD, as Management saw this reduction in fees as a means to enhance the attractiveness of the Equity Participation Fund investment.<sup>5</sup> As a result, available resources for administering the Equity Participation Fund sourced from limited partners for their share of the equity portfolio are about 25 per cent of comparable market-based PEFs. Aligning the interests of both limited partners and the EBRD is achieved by the retained ownership interest of the 70-80 per cent of the direct equity investments that are included in the Equity Participation Fund .

In 2013, it was envisaged that the Equity Participation Fund would be €1.0-1.5 billion and the first closing would occur in early 2014 (EBRD, 2013a). In 2015, the concept was refined following market soundings, and the target fund size was set at €250-750 million, with a term of 12 years from first closing and a target IRR of 15 per cent. In September 2016, the EBRD announced the Equity Participation Fund had achieved its first closing by raising €350 million from sovereign wealth funds in Azerbaijan and the People's Republic of China (*Financial Times*, 2016a).

## 2.3. Previous evaluations

The EvD has prepared numerous evaluations of equity investments since the early 1990s, although most projects and associated evaluations were classified on the basis of country, sector or theme, rather than a financing instrument such as direct equity. Equity evaluations fell into two broad groups: (a) broader thematic studies of equity investments; and (b) specific PEFs that had experienced performance difficulties. The EvD's Thematic Studies tended to provide positive findings about equity investments, although institutional weaknesses were a recurring theme. PEF evaluations presented relatively poor results, although selection might have been based on a desire to explore the cause of problems (see Annex 2 for further details on the EvD's previous equity evaluations).

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<sup>5</sup> The EBRD will act as the fund manager, whereas the GP will be a signatory and the executive body of the Equity Participation Fund. The EBRD will appoint one member to the Board of Directors of the GP to ensure there is effective EBRD governance of the GP. The other directors of the GP are professional nominee directors, appointed by the fund administrator that was appointed by the EBRD.



# 3

## Evaluation of the EBRD'S equity portfolio

## 3.1. Strategic content

### Key facts and findings

- Equity has a strong theoretical rationale: that it will achieve transition impact, as decision rights on resource allocation are linked to financial returns, which creates strong incentives to achieve results.
- The EBRD does not have a consolidated strategy that sets out how it will use equity investments to produce an identified set of outcomes, and interventions have been partial and fragmented.
- Management views equity as an important potential source of income, and it has developed the Enhanced Equity Approach to bring about a cultural transformation within the EBRD staff and strengthen equity performance.
- Low levels of equity investment in countries of operations are only partly a function of the macroeconomic instability that followed the global financial crisis; more importantly, they are due to weak institutional arrangements relative to other regions.
- Equity was acknowledged as an important instrument in the EBRD Capital Resources Reviews and Local Currency and Capital Markets Initiative (LC2).
- Equity was assigned a prominent role in the EBRD's financial sector strategies, whereas it was not treated as a high priority in the infrastructure sector strategies.
- Equity can play an important role in country strategies, but this potential has not yet been realised.

#### 3.3.1 The role of equity

Equity finance has a strong theoretical justification: that it will achieve improvements in economic transition. The shareholders' residual claims to a firm's cash

flows, coupled with management decision rights, create 'high-powered' incentives for them to pursue activities such as improvements in productivity, increases in capacity and job creation. As a result, equity is integrally linked with transition impact in the EBRD countries of operations, through its relationship with market structural reforms, privatisation and the transfer of assets from state to private ownership and management, as well as the opportunities it creates for open access to markets and resources for new investment in sectors such as infrastructure or SMEs.

The privatisation programme and associated structural reforms initiated in the early 1990s contributed to a sustained period of growth in the countries of operations, as did their reintegration into the global economy through measures such as accession to the European Union (EU). From 1992 to 2009, the central and eastern Europe region grew at an annual rate of 3.5 per cent in real terms (IMF, 2012). This growth led to rapid improvements in incomes in many countries, although in some this proved to be unsustainable. The EBRD Transition Report (EBRD, 2016a) showed that in the lead up to the financial crisis in 2007, there was a property boom in many countries of operations. Subsequently, there was a correction in asset prices that meant growth was lower than the levels achieved in previous periods (IMF, 2016a).

The global financial crisis precipitated a Eurozone debt crisis that caused cross-border flows of capital and foreign direct investment in countries of operations to contract, and credit growth was weak. Post-crisis levels of investment are below those in comparable regions, and income levels stopped converging with advanced economies. The EBRD Transition Report (EBRD, 2016a) suggested new funding sources were needed to boost investment, and noted the challenge was not only to increase the quantity of finance, but also to rebalance its composition and improve quality. There was a need to reduce the Eurozone's reliance on foreign currency debt and increase the use of local currency equity.

Evidence presented in the Transition Report indicated that private equity investments in companies in countries of operations had positive effects on capital investment, productivity and employment. These translated into higher levels of revenue, profit and employment relative to similar companies that did not receive private equity finance. Despite these benefits, relatively few firms in the region attracted private equity investment. As Figure 2 shows, in 2014 the region received about 5 per cent of all private equity

capital that was invested globally, compared with an 18 per cent share of foreign direct investment and gross domestic product (GDP). Furthermore, the region's share of total private equity investment in emerging markets declined during the period 2011-14.

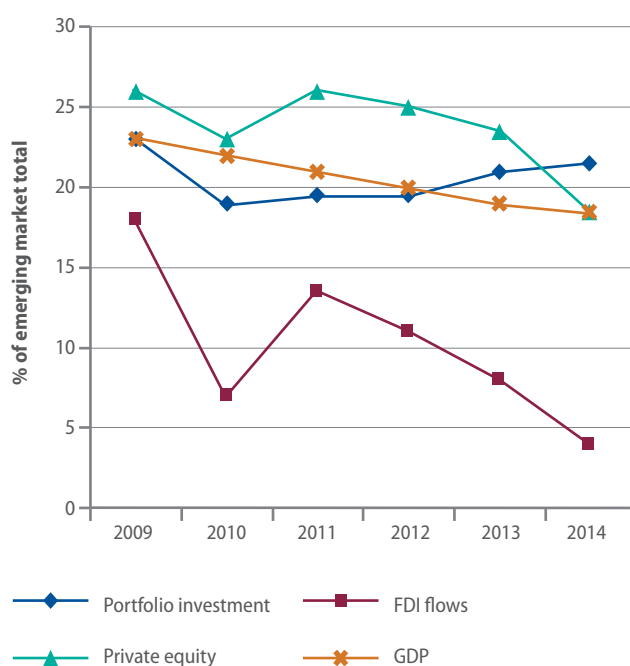
Portfolio flows in countries of operations, consisting of public equities and debt securities, had a fairly stable share of investment in emerging markets. By comparison, the countries of operations did not keep pace with other emerging markets attracting long-term foreign direct investment and medium-term private equity investments. Figure 3 shows that the trends in PEF investment in countries of operations highlighted in the Transition Report were persistent. Private equity investment during 2011-15 averaged about 4 per cent of the global total, but declined overall during that period.

The Transition Report (EBRD, 2016a) noted investment is a function of such factors as macroeconomic stability and the poor quality of the institutional environment, although the latter is dominating in countries of operations given the regional divergence in investment following the global financial crisis. A range of institutional factors constrain equity investment, such as an inability to enforce shareholder agreements, the non-disclosure of non-financial data, and weak corporate governance to protect minority investors. Exiting investments via IPOs is harder in countries of operations than in more advanced economies, due to the lagging level of capital market development.

Policy-makers can take various actions to relax these constraints, such as: (a) strengthen corporate laws to ensure that minority investors have exit rights, and that accounts are properly audited and disclosed; (b) reduce regulatory uncertainty in areas including regulated infrastructure tariffs, tax and property ownership; (c) strengthen judicial capacity to enforce contracts; and (d) support the establishment of stock exchanges to mobilise funds and enable exits.

IFIs such as the EBRD can support this process through the provision of policy dialogue, technical cooperation and sovereign loans to develop institutional capacity within government that will create a feasible enabling environment for equity investments. *IFIs can provide non-sovereign equity funds to the private sector, giving firms the opportunity to test new enabling environments, gain experience in using equity, and make investments that generate economically important transition impacts.*

**FIGURE 2. EBRD REGION'S SHARE CAPITAL FLOWS AND GDP ACROSS EMERGING MARKETS, 2009-14**



Source: EBRD (2016a)

**FIGURE 3. GLOBAL PRIVATE EQUITY CAPITAL RAISING**



Source: EMPEA (2015)

Box 3 provides information on the lifecycle of private equity investments.

### 3.1.2 The EBRD's strategies

The EBRD has not produced a consolidated strategy for its equity operations. The primary EBRD documents governing the use of equity are: (a) Bank capital frameworks; (b) the LC2 initiative; (c) sector strategies; (d) country strategies; and (e) the Enhanced Equity Approach.

#### ***Bank capital frameworks***

The EBRD's overarching strategic programme is governed by capital framework documents approved at its annual meetings, usually in five-year intervals. Since 2006, Capital Resources Reviews have assigned equity a similar role to instruments such as debt and guarantees.

During the third Capital Resources Review (2006-10), the EBRD intended to continue shifting its portfolio towards the early and intermediate transition countries and Russia, while addressing transition opportunities in advanced countries. The third Capital Resources Review noted that the EBRD would continue to develop its competence in new activities, products and sectors relevant to the implementation of its mandate within a changing transition and business environment including capital markets instruments and equity, local currency financing and public-private partnership financing structures. The fourth Capital Resources Review (2011-15) acknowledged the impacts of the global financial crisis and indicated that a primary objective was the development of the portfolio 'East and South', with particular attention to early transition countries and the western Balkans, while building up a new portfolio in Turkey. The equity share of the portfolio was projected to remain broadly constant over the fourth Capital Resources Review period, at around 23 per cent.

The Strategic Capital Framework for the period 2016-20 (EBRD, 2015c) reinforced earlier transition objectives and noted new factors, such as the need to re-energise transition, the importance of climate change and the new Sustainable Development Goals. It also noted that the EBRD had incurred its first financial loss – of €568 million – in 2014, including €1.03 billion of unrealised reductions in equity valuations. There was a need to reinvigorate reforms and broaden the scope of the EBRD operations to pursue such objectives

### Box 3. The lifecycle of private equity investments

Typically, investments in private equity are categorised according to the following lifecycle for investee firms:

- seed funding, usually from individual 'angel' investors
- venture capital from institutional investors' pooled funds, which are used to develop high-risk companies taken over from angel investors
- growth equity, which can include mezzanine financing (subordinated debt and hybrid equity), and minority and controlling equity interests
- distressed assets, which are experiencing cash-flow problems and require external equity.

This continuum reflects a declining level of risk, with the greatest volumes of funding tending to be required within a firm for growth or, more recently, recapitalising distressed assets. IFIs can potentially invest at any point along this spectrum, depending upon their objectives and the feasibility of investing within a country.

as inclusiveness, resilience, integration and tackling climate change. The Strategic Capital Framework highlighted the EBRD's intention to develop partnership structures with institutional investors that would enable them to co-invest with the Bank in debt and equity transactions in the region.

#### ***The Local Currency and Capital Market Initiative***

The financial crisis of 2008 highlighted risks arising from excessive reliance on foreign currency funding in countries of operations, and the need for greater use of local sources of debt and equity from private and capital markets. In November 2013, the Board approved LC2. Subsequent to this approval, LC2 was identified as one of the Bank's three primary strategic priorities.

Within this initiative, country diagnostics were prepared and technical cooperation programmes implemented to facilitate the increased use of local currency debt and equity. To date, most of these efforts have been directed towards developing local currency capital markets, and equity constraints did not feature prominently in country analyses.

## **Sector strategies**

Following the global financial crisis, equity was seen as an important instrument in the financial sector to recapitalise banks. By comparison, the infrastructure sectors (energy, transport, and municipal and environmental infrastructure) and industry, commerce and agribusiness appear to have simply scaled back on investment, with no compensating shift to equity. As a result, over the evaluation period, equity was assigned a prominent role in financial sector strategies, whereas it was not treated as a high priority in the infrastructure sector strategies, and there was no formal strategy for industry, commerce and agribusiness. While equity was treated as important in the financial sector and acknowledged in the infrastructure sectors, there was little sense in the EBRD sector strategy documents of differences in scale of allocations across sectors, regions or stage of investee lifecycle, or even a shift in emphasis over time.

## **Country strategies**

A high-level review of the EBRD country strategies shows that while equity investment is rarely an objective in its own right, direct investments and PEF funds were frequently mentioned as instruments that could be used to help structure projects. However, these documents tended to provide a description of the operations in the previous period and identified likely areas of priority in the subsequent strategy period, rather than making a clear statement of intent. There is a lack of clarity on the coordination of enabling activities and investments, and the availability of technical cooperation to finance these activities.

## **Enhanced Equity Approach**

The EBRD does not have a strategy for equity and it relies upon several 'approaches' (see Annex 1 for further details). In March 2017, Management explained to the Financial and Operations Committee that this was necessary because an equity development programme could not be defined easily and therefore Management's focus should be on operations. In the past, the EBRD managed direct equity and PEFs separately. There tended to be greater scrutiny of PEFs than direct equity, as evidenced by regular annual Board presentations on PEF portfolio performance and EvD evaluations of PEFs. Management started to produce an overview of the financial performance of the EBRD equity investments on a portfolio basis in 2013.

**Private equity funds:** The approach for the PEF programme has been based on two broad objectives: (a) efficiently deploy equity capital to companies; and (b) build a sustainable private equity industry in the region. In 2012, Management presented an 'integrated approach' to the Board, where EBRD-financed PEFs would, among other activities, contribute to LC2 by working on the supply side to help promote the effective deployment of local pools of institutional capital (particularly pension funds). In 2013, the Board approved the Integrated Approach for the Further Development of the Venture Capital and Private Equity Ecosystem in the Baltic States. This would enable the EBRD to address transition challenges in the Baltic states' venture capital and private equity ecosystem, and deliver transition impact through policy dialogue and investments into venture capital funds and PEFs.

**Direct equity:** A direct equity approach started to become visible only in 2013 when the EBRD introduced the Institutional Investment Partnership Initiative (EBRD, 2013b). This was designed to provide a means of establishing strategic partnerships with institutional investors. The amount of funds managed by sovereign wealth funds and insurance firms had grown rapidly, and increasingly these funds were being channelled into emerging market investments (IMF, 2016b). Despite this growth, equity investments in the EBRD regions of operations were limited. The Institutional Investment Partnership was designed to address this concern by providing a vehicle by which institutions could co-invest with the EBRD in its countries of operations. It was envisaged that the long investment horizons of these investors would mitigate the shorter-term focus and capital constraints of traditional banking partners, and provide the EBRD with additional risk capital capacity.

In 2014, the declining performance of the direct equity portfolio had become apparent, and Management initiated an operational review. On the basis of this review, the EBRD developed the Enhanced Equity Approach, which was presented to the Board in April 2016. The Enhanced Equity Approach made the case for building an equity culture within the EBRD through two pillars:

Pillar 1: Strengthen the internal enabling environment within the EBRD by establishing a dedicated Equity team that is involved in execution, and using 'soft' volume targets to source equity transactions.



Pillar 2: Enhance equity investment guidelines through the adoption of a value-creation approach to the management of the portfolio of equity investments.

In March 2017, Management made a second presentation to the **Financial and Operations Committee** that provided an update on the **Enhanced Equity Approach**, indicating that Pillars 1 and 2 were now in place and it was time to move to Phase II and focus on income generation (EBRD, 2017b). This indicated an expectation of a scaling-up of equity operations.

### 3.2. Structure of the equity portfolio

This section reviews the EBRD's equity investment programme and whether the levels of investment in equity, supporting institutional arrangements, management and staffing levels, information systems, budgeting and monitoring and reporting arrangements were sufficient to achieve the stated objectives. The evaluation assesses this by reviewing the management reports and financial accounts presented to the Board on the allocation of the equity portfolio, by type of instrument, country, sector, size and duration of investments.

It is noted that data on the equity portfolio is subject to significant lags, particularly for PEFs, as the accounts need to be prepared by investee companies, consolidated by GPs and then passed back to limited partners such as the EBRD. Most of the data presented in management reports to the Audit Committee focused on flows of equity approvals within a particular year; there is limited information available on the stock of investments or divestments. These reports are qualified and the data on fair values do not appear to be fully consistent with International Financial Reporting Standards.<sup>6</sup> It is understood that management data are reconciled with financial accounts, but it is not clear where differences are occurring and whether these differences are significant.

<sup>6</sup> According to EBRD internal documentation, fair value is based on the accounting valuation. Fair value does not reflect a small number of adjustments made by Financial Accounting for reporting purposes. Fair-valuing of the EBRD portfolio assets under International Financial Reporting Standards started in 2005. For the years preceding, the Bank generally held investments at cost unless impaired. There have been continuous adjustments in figures as they were discovered. This is because prior to the implementation of the equity system, equity transactions were not recorded in a consistent manner across all equity products; and fair value does not reflect a small number of adjustments made by financial accounting for reporting purposes.

## Key facts and findings

- The quality of data at the portfolio level is poor, due to several characteristics of equity that result in lags in reports. Further, fair values do not appear to be fully consistent with International Financial Reporting Standards, and it is not clear whether these differences are significant.
- There is no clear link in reports between volumes of investment or the availability of staff and funding for due diligence, ongoing operations and divestments.
- The volume of annual investments in equity has been, on average, about €1.0 billion per annum, and the size of the portfolio has fluctuated around the level of €6.0 billion in recent years.
- Equity and debt instruments tend to be allocated to separate firms and most of the portfolio is structured as pure equity, with limited use of mezzanine finance (see Box 4).
- Russia and, more recently, Cyprus, Greece and Turkey have dominated the portfolio by region, but high levels of regional concentration have made the portfolio vulnerable to macroeconomic shocks.
- The dominant sector in the portfolio was financial institutions (FIs), with limited exposure to infrastructure.
- The portfolio has a large number of small investments coupled with a small set of very large exposures. In total, 34 per cent of the portfolio by value is allocated to projects exceeding €100 million, indicating poor use of staff to achieve transition impacts, and concentrated client risks.
- Some of the portfolio investments are very old, exceeding 20 years of age; 27 per cent of the

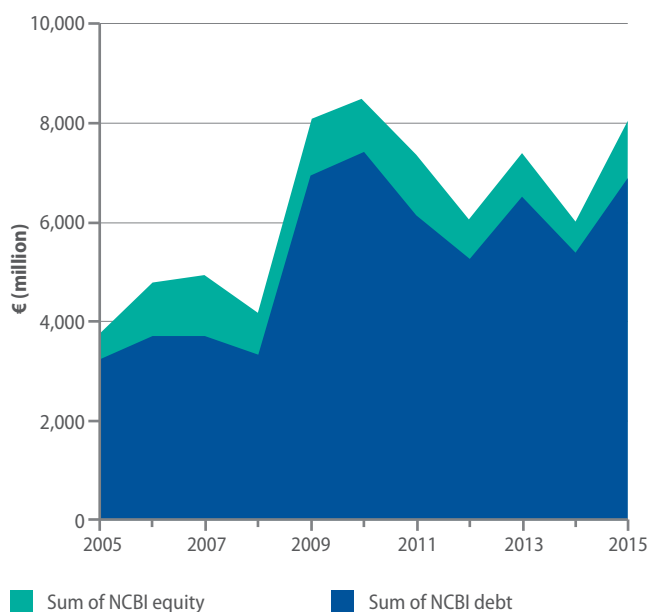
portfolio by fair value exceeds the maximum target life of seven years, indicating substantial unutilised transition impact capacity within the portfolio.

### 3.2.1 Financial allocation of the equity portfolio

Figures 4 and 5 present the net cumulative bank investment allocated to debt and equity. These figures show the amount allocated to equity was around 15-20 per cent of net cumulative bank investment (NCBI), although this declined slightly in absolute and proportional terms after a ramping up of lending volumes in 2009 in response to the financial crisis.

The size of the portfolio has stabilised at about €6.0 billion original cost in recent years, with €4.6 billion being allocated to direct equity and €1.4 billion to PEFs at December 2016. An analysis of the allocation of investments by type of instrument over the evaluation period indicates that the amount of overlapping debt and equity was small. This suggests that neither equity nor debt were commonly used as pathfinding instruments that were then used to justify additional EBRD finance using sequenced instruments (i.e. equity then debt, or debt followed by equity).

**FIGURE 4. PORTFOLIO GROWTH 2005-15 BY INSTRUMENT (€ MILLIONS)**



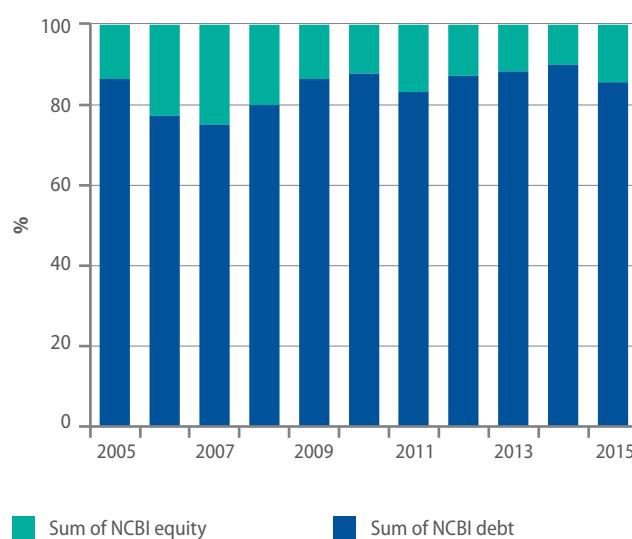
Source: EBRD records  
NCBI = net cumulative bank investment

Where investments in debt and equity were combined into a single transaction, there was no common structure and the method of classification was not clear. In some cases, the classification appeared to be driven by the combination of put options with equity (portage), to transform the equity instrument into quasi debt. An analysis of direct equity investments (EBRD, 2014b) showed about 10 per cent of equity investments from 2004 to 2013 were structured as mezzanine finance (see Box 4). Similar to direct equity, PEFs occasionally used mezzanine finance, but in most cases they relied on traditional private equity. Figures 6 and 7 show the rankings and allocations of equity by region over time.

The main geographic groups were: (a) regional investments (presumably funds); (b) Russian investments; (c) central Europe and the Baltic states (CEB) investments that provided the backbone to the portfolio and were relatively constant over time; and (d) Cyprus, Greece and Turkey. Russia accounted for 27 per cent of annual investment over the period, even though investment went to 0 per cent from 2014. In 2014-15, Cyprus, Greece and Turkey accounted for 50-60 per cent of annual investment, starting from a base of close to 0 per cent in 2013.

Figure 8 shows equity investments by sector. Investments in FIs dominated, indicating a high level of sector concentration. The balance of the investments was in infrastructure and non-infrastructure sectors.

**FIGURE 5. PORTFOLIO COMPOSITION 2005-15 BY INSTRUMENT (%)**



Source: EBRD records  
NCBI = net cumulative bank investment

## Box 4. Mezzanine finance

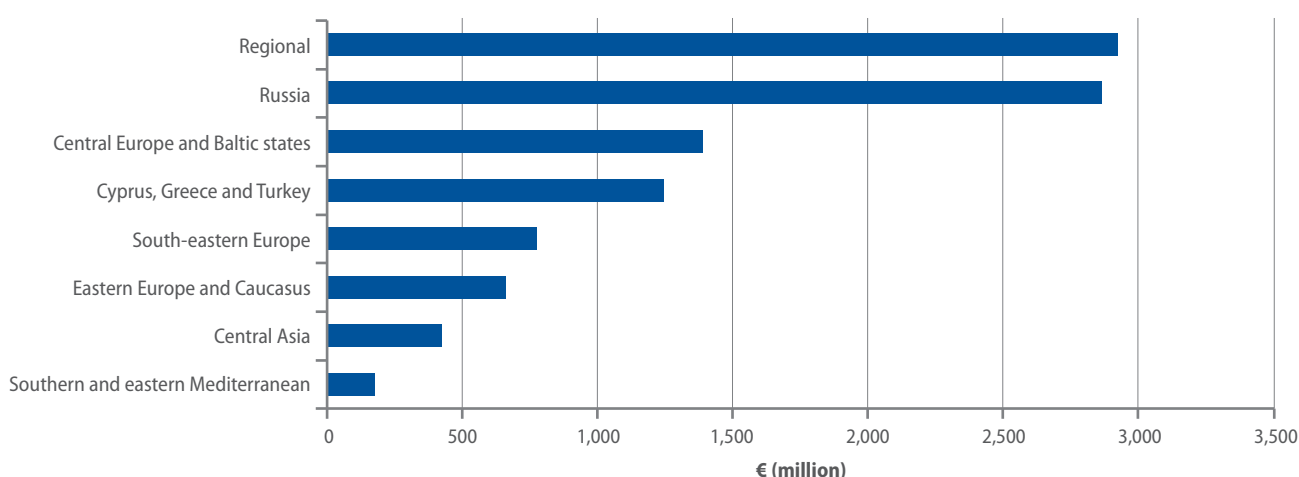
**Mezzanine finance** is a hybrid financial instrument that falls between equity and debt. There is a range of alternative structures that can be used.

- **Subordinated loans** usually do not provide collateral and have a lower repayment priority than senior loans in the event of default (i.e. subordinated debt-holders are not paid until senior debt-holders are paid in full). The currency of the financing can be specified in the loan agreement.
- **Convertible debt** refers to initial financing through a conventional loan with periodic interest

and capital repayment in a defined currency. The instrument provides the investor with the option to convert the loan to a certain number of shares at a predefined price at some future date.

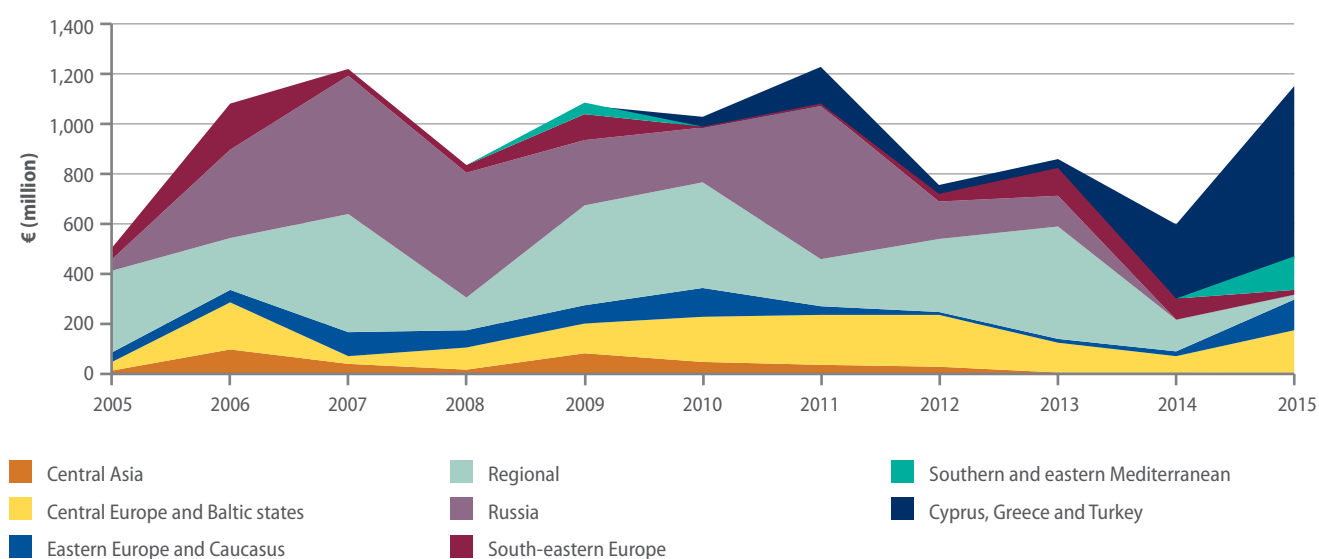
- **Preferred stock** usually receives a defined dividend that is paid out after debt holders have been paid in full, but before dividends are paid to common shareholders. Preferred stockholders usually do not have voting rights or collateral, but they can define currency and redemption arrangements. In some cases, preferred stock carries the option of conversion to common shares.

**FIGURE 6. INVESTMENT ALLOCATION (2005-15) RANKING BY REGION (€ MILLIONS)**



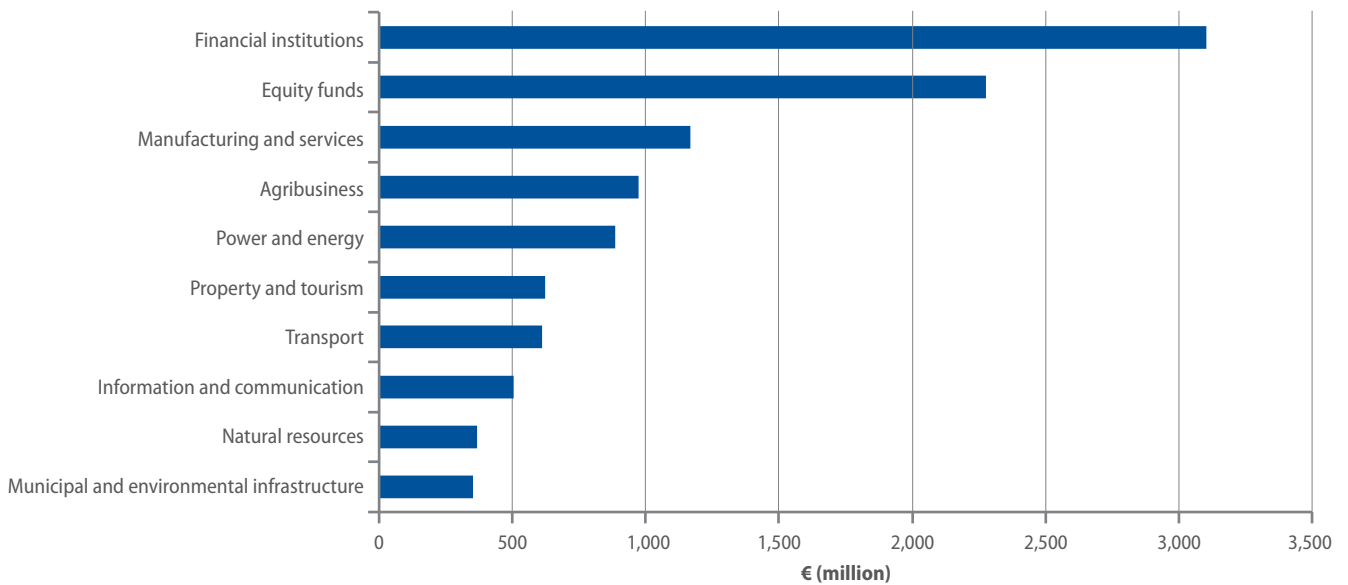
Source: EBRD records

**FIGURE 7. INVESTMENT ALLOCATION (2005-15) BY REGION (€ MILLIONS)**



Source: EBRD records

**FIGURE 8. INVESTMENT ALLOCATION (2005-15) BY SECTOR (€ MILLIONS)**



Source: EBRD records

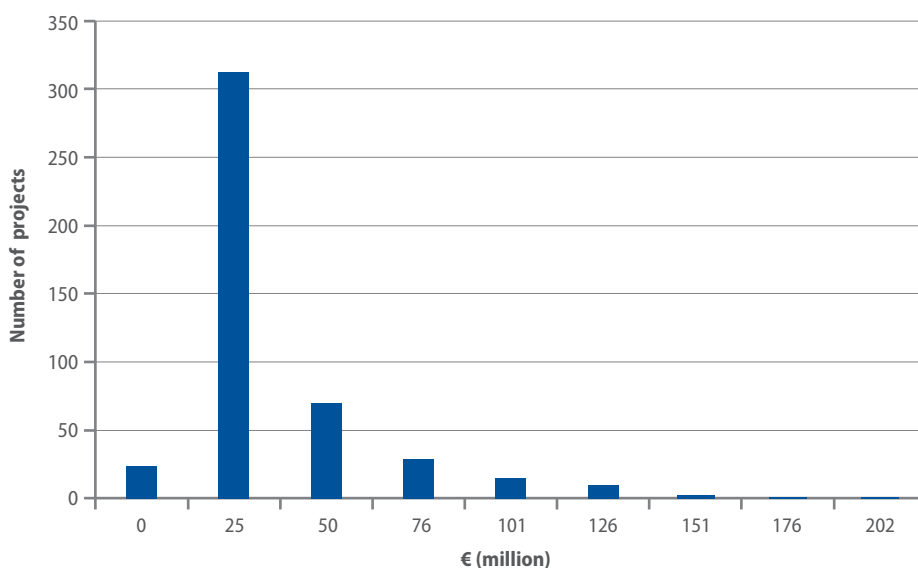
There is no classification of the portfolio based on stage of lifecycle, although most of the portfolio appears to have been allocated to growth or, more recently in the case of FIs, recapitalisation.

As Figure 9 indicates, 70 per cent of projects approved over the evaluation period were smaller than €25 million. These projects will consume large amounts of staff time compared with the magnitude of expected transition impacts. The distribution of the size of the current equity investments was highly skewed to the right and, at 31 December 2015, there were 14

projects that had investments of €100-200 million. At 31 December 2016, as shown in Figure 10, 34% of the direct equity portfolio by value was invested in projects exceeding €100 million. These results indicate high levels of concentrated client risk.

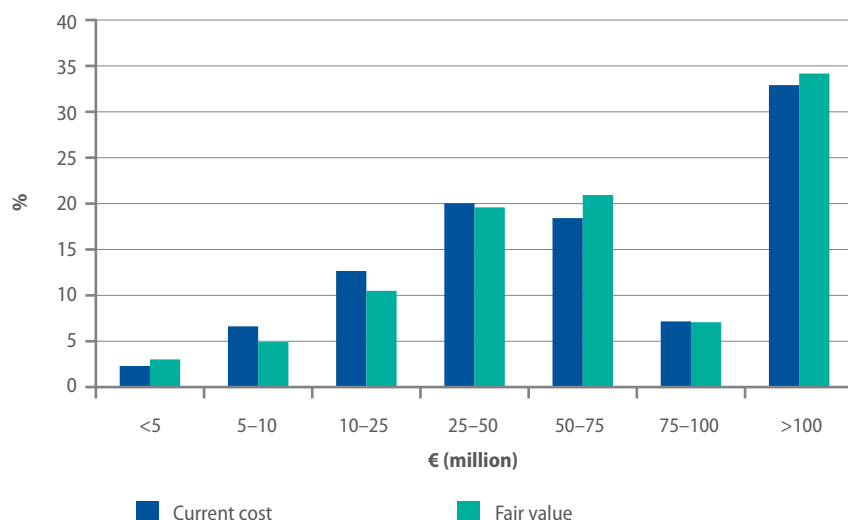
There are limited data available on the distribution of the stock of equity assets by age, original cost and fair value. An analysis of the distribution of the age of the equity investments by number realised in 2014 indicated that this ranged from 2.5 to 21.1 years, and averaged 7.4 years (EBRD, 2015d). In 2017, Management reported

**FIGURE 9. DISTRIBUTION OF EQUITY INVESTMENTS BY SIZE**



Source: EBRD records

**FIGURE 10. DISTRIBUTION OF DIRECT EQUITY PORTFOLIO BY SIZE**



Source: EBRD Records

that 48 projects out of 210 investments (23 per cent) in the current portfolio were one year or less in age, and 77 (37 per cent) were aged from 7 years to greater than 20 years, and accounted for 27 per cent of investments by fair value. As these investments exceeded the maximum expected date, coupled with the nature of transition impacts, it seems likely that many of these investments are no longer generating transition impacts.

### 3.3. Organisational arrangements, resources and skills

#### Key facts and findings

- In 2014, following the recognition of the deterioration of the financial performance of the equity portfolio from 2004, an operational review and a series of reforms were implemented, which culminated in a presentation to the Financial and Operations Committee on the Enhanced Equity Approach in 2016.
- The Enhanced Equity Approach brought the direct equity and PEF operations under a single managing director, transferred responsibility for management of the direct equity portfolio

to a new value-creation unit, and increased the number of bankers engaged in sourcing and executing equity transactions.

- Institutional responsibilities for transacting and managing equity have become very complex and undefined; most equity staff are bankers rather than equity specialists; and staff resource levels for equity are no more than 50 per cent of industry norms, and may be substantially less.
- Equity reporting arrangements for the Board have been unstructured and not properly sequenced to allow results and data on current resource allocations to guide strategy deliberations; and the archiving of Board reports is ad hoc.
- The Enhanced Equity Approach update in 2017 indicated that the Equity Group will prepare financial statements, but details were not provided on the scope, timing and sources of funding.
- Staff incentives are creating an approvals culture that does not support the management of the capital in the underlying portfolio to maximise transition impacts and financial returns.

### 3.3.1 Overview

The EBRD's organisational structure needs to balance incentives carefully to manage various forms of financing instruments and maximise transition impact potential. The provision of both debt and equity within a single management structure creates the potential for conflicts of interest between transition, banking and investment roles. The purpose of an equity investment is to create value in the investee company and exit through a sale to a third party. The purpose of a loan is to receive a fixed series of interest payments and recover the principal through payments from the sponsor. The lender wants to ensure the debt is paid on time, irrespective of whether the company continues to develop or they are paid through liquidation of assets (collateral).

By comparison, a pure equity investor is exclusively concerned with improving the performance of the company and the residual equity return, even at the expense of the lenders. Governments and commercial borrowers have the potential to be concerned when the EBRD invests in both equity and debt in competing firms, due to its ability to access 'insider information' and profit from this. These problems are further exacerbated when companies are publicly listed and subject to insider trading laws.

The EBRD has prepared several staff guidelines to minimise the risks of conflicts of interest and guide project processing. These include: Put and Call Options in EBRD Projects, Issues and Operational Committee Guidelines, December 2000; EBRD Equity – Policies, Processes and Strategic Issues, prepared for the Financial and Operations Committee in July 2009; a Draft Equity Policy Guideline on the EBRD intra-web, dated April, 2010; and the Investment Policies and Product Guidelines (formerly Portfolio Risk Management and Investment Policies), which were presented to the Board on 4 June 2013. These guidelines include provisions that require:

- full disclosure to all relevant parties of the EBRD's debt and equity involvement
- that, in most cases, the equity exposure is significantly smaller than the debt exposure and it is acknowledged that protection of the loan will be a priority in a 'distress' situation
- each instrument to have, normally, separate Operating Leaders and team members

- no cross subsidy is assumed in the project analysis
- a target return on equity of 20-30 per cent.

After recognising the deterioration of the financial performance of the equity portfolio from 2004, an operational review and series of reforms were implemented in 2014 to establish an EBRD 'Equity Platform' to change the way it manages its equity portfolio. This review culminated in the presentation of the Enhanced Equity Approach to the Financial and Operations Committee in 2016, describing the revised institutional structure that had been put in place from 2014 to 2016.

### 3.3.2 Governance arrangements pre-2014

#### *Organisation structure*

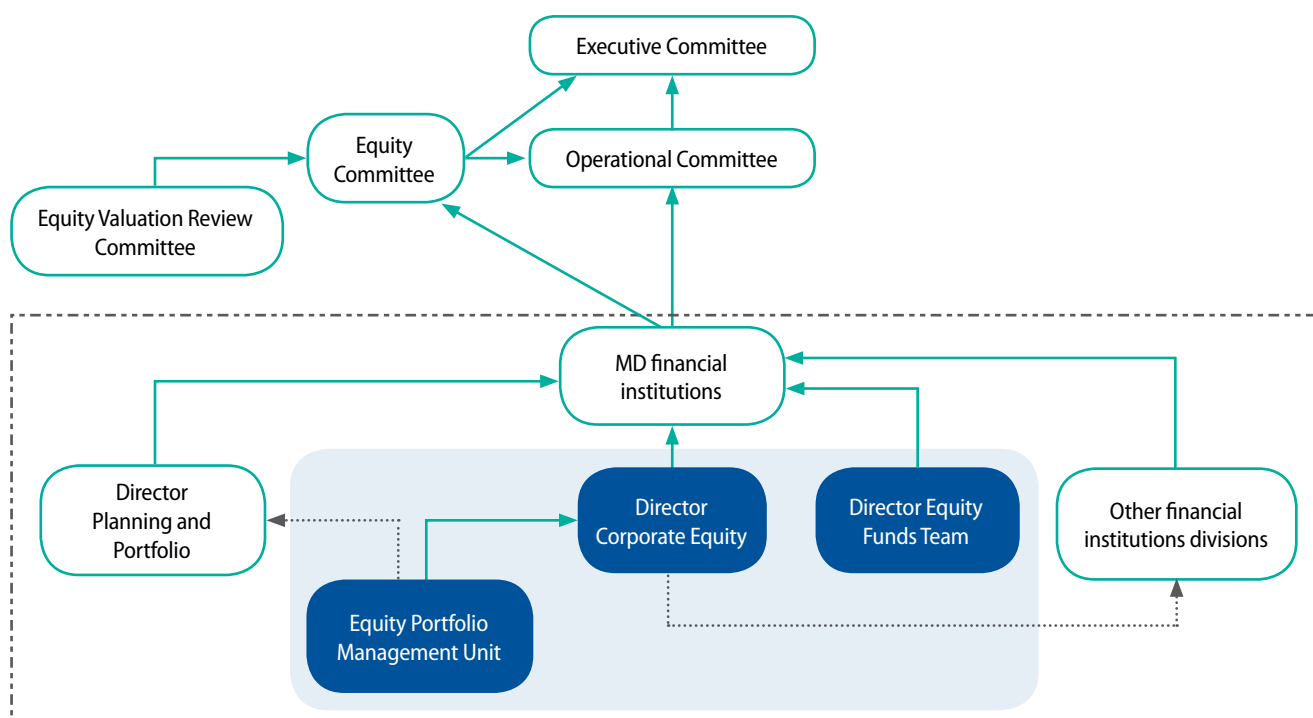
Figure 11 illustrates the organisational arrangements for equity before 2014 and the start of the process to create the Enhanced Equity Approach.

The Executive Committee is responsible for strategic and policy issues, and the Operational Committee for operational matters. The **Equity Committee** reports to these committees, having management oversight of the equity portfolio. Composed of senior staff, the **Equity Committee** reviews investment proposals, monitors progress on the attainment of transition and financial objectives for the equity portfolio, reviews its overall composition, and identifies listed investments suitable for exit.

The **Equity Valuation Review Committee** is responsible for ensuring consistent methods for making valuation standards are used for the equity portfolio. Equity investments have a number of unique features that make portfolio management challenging compared with debt. They have a long life; they are denominated in local currency; there is a high level of correlation with macroeconomic conditions; there is no asset-backed collateral; and they lack investment liquidity even when listed, making valuations difficult. Before 2005, the EBRD generally applied the prevailing European Private Equity and Venture Capital Association principles for direct investments. From 2005 onwards, the EBRD has valued its portfolio assets based on fair value, as defined by International Financial Reporting Standards.

Pre-2014, the FI department was primarily responsible for equity, and PEFs were recognised as a separate asset

**FIGURE 11. EQUITY OPERATIONS ORGANISATIONAL STRUCTURE, PRE-2014**



class that was pooled in the FI Group in the **Equity Funds team**, rather than being allowed to operate throughout the Bank. A **Corporate Equity team** was established in the FI Group in 2009, to act in an advisory capacity to bankers to improve the quality of direct equity investments by: (a) providing a centre of expertise in equity; (b) ensuring that (quasi) equity transactions were properly structured and managed by providing pre- and post-investment input to all Banking teams undertaking direct or indirect corporate transactions; and (c) promoting 'best practice' standards on the use of the equity product throughout the EBRD. A combination of Bank staff and external directors sat on the boards of the companies, and reported to account managers.

The **Equity Portfolio Management Unit** (EPMU) was established in 2008, reporting to the Director, Corporate Equity. The EPMU was created as part of the implementation of the EBRD dedicated equity information technology system, Accounting Frameworks Limited. This management system provides data for the analysis and management of the equity portfolio. The EPMU captured valuation models and quarterly risk reports. In 2014, the EPMU started to use new report formats in project preparation and monitoring, based on updated equity term sheets and company value creation plans. In addition to these core equity operations, there were various small regional funds, such as the Local Enterprise Facility, which

often used non-Bank sources of donor funds and were managed by regional departments, independent of the equity operations.

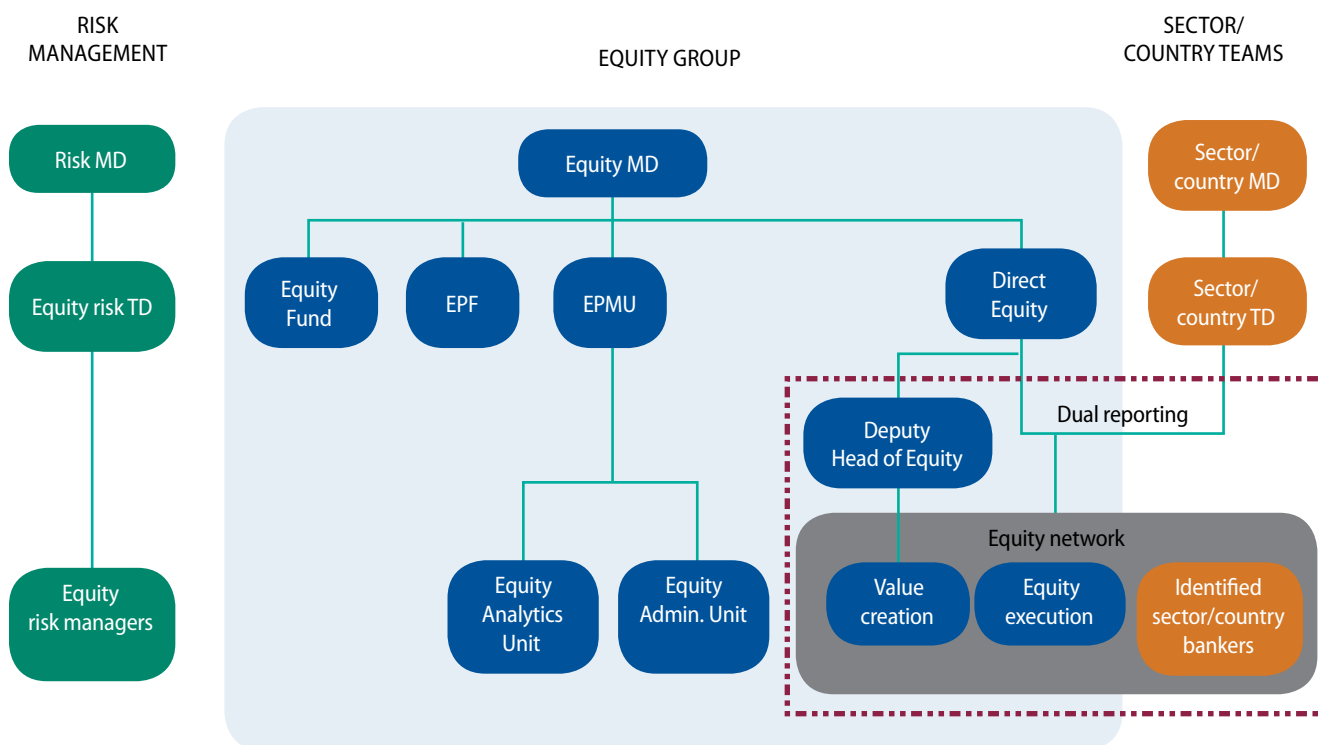
### 3.3.3 Governance arrangements from 2014 onwards

#### *Organisational structure*

In 2014, the EBRD reviewed its organisational arrangements for managing equity and implemented a major process review in collaboration with the consulting firm PwC. The main findings of this review were the need for a dedicated Equity team that was responsible for the whole equity portfolio, and that equity investments should be managed from a value-creation perspective. Following this review, the Enhanced Equity Approach defined a new organisational structure in 2016, presented in Figure 12. The structure is designed to strengthen the equity culture within the EBRD and enhance decisions over the equity investment lifecycle.

This new structure introduced the Equity Participation Fund, but it did not include the small regional funds, which remained separate and were merged into a Direct Financing Facility in 2015, with oversight responsibility being delegated to the Small Business Investment Committee.

**FIGURE 12. PROPOSED INSTITUTIONAL ARRANGEMENTS UNDER THE ENHANCED EQUITY APPROACH**



EPF = Equity Participation Fund; EPMU = Equity Portfolio Monitoring Unit; TD = Team Director  
Source: EBRD (2016b)

Under the new institutional arrangements for equity, the Executive Committee was delegated additional powers from the Operational Committee so it could take a top-down view on equity decisions, including exits from all equity investments, rather than just listed equities. There is an intention to revise the Operational Committee agenda so that debt and equity components are reviewed sequentially, to help avoid conflicts of interest.

### Staff resources and skills

A single **Equity Group** was created in 2014 to encompass the EBRD's equity activities for direct equity, PEFs, the Equity Participation Fund and the EPMU.<sup>7</sup> The Equity team members' mandate was extended from an advisory role to acting as a full member of the transaction team. A **Deputy Head of Equity Group** was appointed and made responsible for four value creation leaders (portfolio managers) from the dedicated Direct Equity team, plus 21 senior sector bankers who were client managers responsible for managing the direct equity investments. Collectively, the portfolio managers and client managers are referred to as the **Equity Network**. A dedicated equity

due diligence budget of €1.0 million was created to support the Equity Network activity.<sup>8</sup>

The EBRD intends to continue expanding the Equity Network, increase the number of staff working full-time on direct equity, and the number of local equity bankers based in strategic markets. Some of the fees from the Equity Participation Fund will be used to train Bank staff in the management of equity. Management aims to meet the PwC recommendation of achieving the industry norm of an average of six deals per dedicated equity specialist, versus the current level of 11.2, by accelerating exits from small non-core investments and reallocating staff.<sup>9</sup>

In 2016, there were 155 nominee directors responsible for attending board meetings and reporting to account managers in the Banking departments. An **Equity Risk** unit was established in June 2015, which operates in parallel to the Equity Team and Equity Network. An **Equity Forum**, with representation from the sector bankers, the Equity Group and Equity Risk, was established in 2015 and is responsible for the

<sup>7</sup> This list did not include the equity holdings administered by the Small Business Investment Committee and the Property Funds portfolio.

<sup>8</sup> This figure seems extremely low, given an expected deal flow of 35-40 direct equity investments and 8-12 PEF transactions per annum.

<sup>9</sup> Under the Enhanced Equity Approach, it was indicated that 56 small old investments, with a fair value of less than €10 million and 8 years or longer holding period, would be divested, starting from 2016.



early involvement of the Equity Group in investment proposals and the allocation of resources.

There are concerns about the lack of clarity of the role of the Equity Group versus the bankers, however, and the lack of specialist equity skills. While the Equity Group is meant to have full control of equity, it has very limited resources, and no veto that can be exercised if the projected financial performance of investment proposals does not meet the minimum requirements.

### **Staff incentives**

Under this new organisational structure, there is an intention to manage the direct equity portfolio more proactively. Shareholder agreements will have strong negative controls and there will be clearly defined value creation plans. Scorecards have been developed that define bankers' responsibilities **and 'soft' targets in the form of the expected number of equity transactions they are expected to process each year.**<sup>10</sup>

However, the volume incentives for bankers create the risk of developing an approvals culture at the expense of the staff managing the equity portfolio, who are measured on the basis of transition impacts and financial results. Under the new structure, there will be an increased use of external nominee directors versus staff. Procedures have been developed to increase the scrutiny of nominee directors' performance, but incentives continue to appear to be weak. There is no performance component of the nominee directors' remuneration, and reporting obligations to relationship and portfolio managers appears vague, in part due to the lack of project milestones and benchmarks for transition impact objectives, and minority shareholder status that reduces their authority to effect change.

One issue with measuring performance during the operating period has been the lack of comparability of the EBRD portfolio performance with internal and external benchmarks. To address this, Management has developed its own in-house benchmark, which will supplement the annual equity volume targets presented in the Enhanced Equity Approach. This new benchmark was approved by the Equity Committee in February 2017, and the portfolio review indicated that it is based on two indices that reflect a dynamic combination of portfolio and market performance indicators. These were combined using multiple

<sup>10</sup>There are company law restrictions on the extent minority shareholders can positively direct the decisions of the other shareholders.

weighting systems across multiple countries, which would then be smoothed across 5- or possibly 10-year time periods. Further refinements were expected to be added over time, to reflect factors such as differences in liquidity or credit risks.

This new benchmark raises concerns, however, due to its lack of objectivity and transparency. Benchmarks need to be based on independent external criteria that remain constant over the life of the project. They also need to compare like with like, rather than being derived using non-transparent methodologies that constantly change over time.

### **Reports to the Board**

The Equity Group reports formally to the Budget Administrative Affairs Committee on budgets, the Financial and Operations Committee on strategic issues, and the Audit Committee on actual performance. Equity Management reports are filed on the **Equity Committee** 'Livelink', and Board reports are meant to be uploaded to 'BoldNet'. The EBRD is investigating new ICT systems to support the management of its equity portfolio, and a **new system is expected to be implemented by December 2018.**

In February 2017, the Equity Group presented to the Financial and Operations Committee on the status of the Enhanced Equity Approach. Management noted that Phase I had put in place the necessary precursors for an equity culture, and the focus in Phase II will be on income generation. Target returns will be set at 15 per cent, although they will vary across sectors, ranging from 8 to 25 per cent. The time frame for exit from investments will be four to seven years, although it is likely to be longer for infrastructure. Sector and country limits for the equity portfolio will be 30-35 per cent, and the single company limit will be 5-7.5 per cent.

In Phase II, staff incentives will be set to achieve these targets based on volume targets for origination by Regional Office Directors and Equity Bankers. The Equity Team indicated that it will prepare its own profit and loss, cash flow and balance sheet statements, but no date was provided on when this might occur, or how it will be resourced. There is an intention to increase co-investments with PEFs and investments in advanced transition countries, but volumes and timings were not discussed.

The Audit Committee receives reports from the Finance Department, Risk and Compliance, and the

Equity Group. The Finance Department and Risk and Compliance provide a Quarterly Performance Report, and Banking (EPMU) provides the equity pages within this report. Due to quarterly reporting intervals, these reports provide limited trend analysis over an extended period and they are highly aggregated, reporting on the Bank as a whole. The Equity Group helps address these concerns by providing the Audit Committee with an annual Equity Portfolio Performance Review that provides more detail; this started to include direct equity in 2013.

The content of these equity portfolio analyses are partial, and they do not link the volume of equity portfolio investments with staff allocations within the EBRD or the availability of funding for due diligence and ongoing operations. It is understood the Audit Committee has agreed to a report template with Management, but it is not clear how it is being applied. The contents of the equity portfolio analyses have varied significantly over the years, and they do not provide sufficient information on critical parameters such as the structure of the portfolio by age and value, and sources and levels of profitability. There is insufficient information provided in the reports on how numbers are derived, and there are uncertainties about the quality of the data, due to the qualifications presented in the notes to the equity portfolio performance reviews.

Furthermore, the presentation of the Equity Report is not synchronised with Financial and Operations Committee meetings. In 2017, the Audit Committee received a presentation on results in March, after the Financial and Operations Committee meeting in February detailing the Enhanced Equity Approach. This underscores the lack of a link between the rationale for the Enhanced Equity Approach and results. Archiving procedures for reports are not defined, and the Equity Portfolio Performance reports included on BoldNet (for future reference by Board members) are subject to varying levels of access restrictions. Consequently, there is a lack of clarity on the status of documents, when they are uploaded, and even which documents to ask for when researching past performance.

## 3.4. Portfolio performance

### Key facts and findings

- Transition impacts tend to be equated with financial performance, or additionality. This latter practice has the potential to create financial risks for the EBRD, as it often has limited ability to mitigate the macroeconomic and institutional risks causing the shortfall in equity investment.
- Direct equity accounts for the bulk of the EBRD's portfolio and, after generating zero returns on vintages from 2005 to 2014, the IRR on the 2016 vintage fell to -12 per cent.
- Equity needs to generate a return of 3.5 times debt to avoid creating opportunity costs for the EBRD on the use of its capital.
- The data indicate the size of opportunity costs and actual losses have been increasing over time, due to growth in the size of the portfolio and declining IRRs on equity investment.
- Results by region indicate that performance deteriorates as the portfolio moves south and east, with the southern and eastern Mediterranean, Russia, and central Asia regions having the highest levels of underperformance, although in 2016 Russia showed some signs of recovery.
- Sector returns in the current portfolio in 2016 indicate that, despite large losses in Greece and Cyprus, FI generated a return of 3.5 per cent and, after a decade of poor performance, energy recovered to 8.5 per cent; however, infrastructure deteriorated further, to -15.3 per cent.
- PEFs consistently outperformed direct equity investments by about 3 per cent per annum, and this amount would increase by a substantial margin if the EBRD management costs for equity were taken into account.

### 3.4.1 Overview

In this section, the evaluation assesses the extent to which the planned outputs from the equity investments were implemented, and the outcomes and transition impacts were achieved. The financial performance of these instruments is then reviewed, relative to internal and external benchmarks and the amount of capital allocated to the equity investments to achieve these results. The link between results and staff incentives is considered. Conclusions are drawn on the magnitude and sustainability of achievements over time.

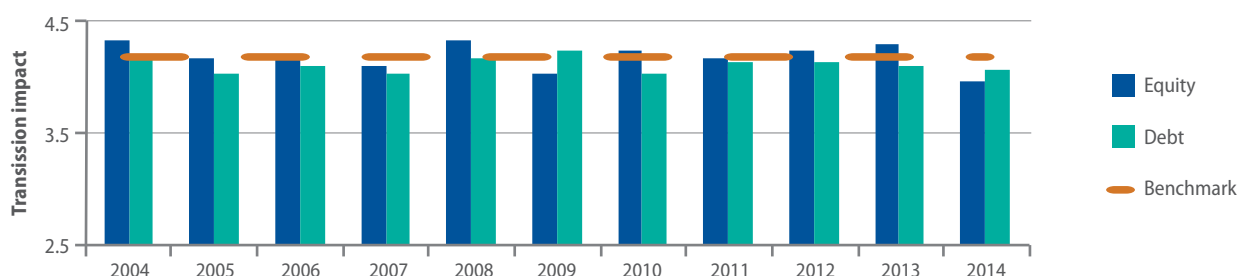
Similar to the review of the equity portfolio and operations, a lack of information on trends in critical variables was an important feature of the review of performance. Transition impacts are not clear and there is no set of financial statements based on profit and loss, cash flow and balance sheet that can be used to provide a clear, standardised, reconcilable review of the structure and performance of the portfolio over time. Management reports on the components of the actual stock of equity investments, and the distribution of the value of unrealised portfolio by year, tend to be partial and hard to interpret. There are no data in Board reports on operating costs for administering the direct equity and PEF portfolios, or capital consumption, which can be used to derive estimates of profitability of equity operations. IRRs presented in management reports are calculated gross of internal EBRD cooperating costs, using numerous different bases with opaque explanations of the underlying assumptions.

### 3.4.2 Analysis of transition impacts from equity investments

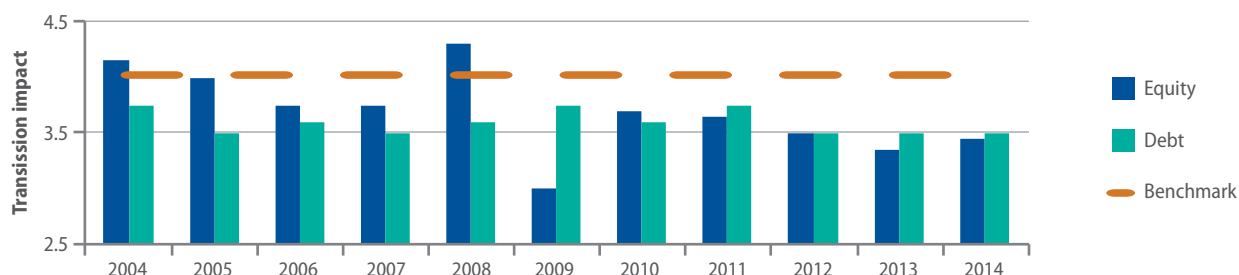
Previous reviews by the EvD and other IFIs such as the International Finance Corporation (IFC), have found that transition impacts, particularly for PEFs, are closely linked to financial returns; in practice, they have to enable the achievement of financial objectives (EBRD, 2002; World Bank Group, 2008). The EBRD Management has presented similar findings that demonstrate how transition impacts and financial returns derived from equity investments are highly correlated (EBRD, 2016b). Research by the EvD on PEFs (EBRD, 2002) indicated that transition impacts were not clearly differentiated from financial performance in project documents and tended to be treated as synonymous.

The implied view that transition impacts and financial performance are the same is unlikely to be correct. While an improvement in the enabling environment may lead to measurable transition impacts and generate financial returns, it cannot be argued that high financial returns lead to transition impacts. In theory, transition impacts are more likely to be clearly specified for direct equity investments, as they are under direct EBRD Management control – but there was no evidence to confirm this result. As Figure 13a shows, equity tended to have higher expected transition impacts at approval than debt. Figure 13b shows that following the financial crisis, actual transition impacts from equity investments exited between 2009 and 2014 were lower than expected, and they underperformed relative to debt.

**FIGURE 13A. EXPECTED TRANSITION IMPACT AT TIME OF SIGNING FOR REALISED PROJECTS**



**FIGURE 13B. REALISED TRANSITION IMPACT AT EXIT**



Transition impact score: Excellent = 5, Good = 4, Satisfactory = 3, Marginal = 2, Unsatisfactory = 1  
Source: EBRD (2015c)

There is little detail in management reports on the actual transition impacts that were expected from equity investments presented in Board documents. Previous evaluations, such as a study in 2014 (EBRD, 2014a), indicated that improvements to corporate governance and shareholder interaction were at the heart of the EBRD's justification for equity investment. The rationale for the Equity Participation Fund presented by Management to the Board was its ability to increase the available pool of equity to invest in countries of operations and enable the EBRD to share risk.<sup>11</sup> This justification is based on the concept of additionality rather than transition impact, which is assumed to be given. In some of the Board documents for equity investments reviewed as part of this study, the argument was presented that as equity is not being provided by the market, the EBRD's equity participation is additional.

This view on additionality does not analyse the reasons why equity is not being provided by the market. In many cases, there are sound financial reasons why equity is not available, based on problems such as poor profit potential, lack of voice due to minority participation, or an inability to exit. In these circumstances, it is not clear how the investment created transition impact, if at all, while at the same time the EBRD exposed itself to risks of incurring future financial losses it did not have the ability to mitigate. Under these conditions, the EBRD is more likely to create TIs by resolving the enabling environment problems, or using financing structures such as PPPs that mitigate these risks, rather than making a direct investment in uncollateralised minority equity shareholdings.

### 3.4.3 Analysis of the financial performance of equity investments

Financial returns were the main indicator used by the EBRD to measure equity performance, and can be compared with a range of benchmarks, including returns from alternative financial instruments such as debt, a target cost of capital that the EBRD traditionally sets at 20-30 per cent, or market comparators (this section draws on EBRD, 2016b; 2016c).

The published data on the equity portfolio do not provide a clear picture of the amount of the EBRD's economic capital that has been consumed, or the amount of committed but undrawn equity for PEFs.

<sup>11</sup> The Institutional Investment Partnership may also provide an umbrella for other non-equity funds financed by third parties, such as a Loan Participation Fund.

## Box 5. Equity benchmarks

A benchmark is a reference measurement to which the portfolio's performance and/or risk is compared. Industry practice on benchmarking of a managed investment pool requires certain minimum quality criteria. First, the benchmark feature must be determined prior to making the investment, not after. Second, as a minimum, the benchmark must reflect the investment mandate, objective or strategy of the portfolio. Finally, the presentation criteria require that the benchmark must be: (a) presented for the same time period; and (b) the same vintage year as the portfolio that is benchmarked.

Source: EBRD (2013c).

These data are important, as the capital charge on the EBRD balance sheet of 70 per cent for equity is 3.5 times the 20 per cent capital charge for non-sovereign debt under its Economic Capital Policy (EBRD, 2014b). Therefore, returns for equity need to generate 3.5 times more profit than debt to avoid creating an opportunity cost for the EBRD.

In 2015, Management prepared an updated equity performance analysis for the Board (EBRD, 2015d) that reported an unrealised equity loss of €680 million, which had been revised downwards from the €1.03 billion reported in the Strategic Capital Framework issued in 2015. The equity portfolio analysis distinguished between two vintage groups for direct equity investments: (a) 1992-2004; and (b) 2005-14. The IRR from the EBRD's portfolio for the first vintage was 13.7 per cent, and this figure fell to 0 per cent for the second vintage.

The investment cost of the first vintage was €6.0 billion compared with an investment cost of €8.1 billion for the second vintage, indicating that losses were growing in euro terms, due to both a decline in IRR and an increase in the size of the portfolio. The IRRs for the vintages in 2014 was -2 per cent, in 2015 -10 per cent, and in 2016 -12 per cent. The equity portfolio as a whole generated unrealised losses of €675 million in 2014, €748 million in 2015, and €468 million in 2016.

The EBRD internal management reports present multiple versions of returns on performance, with little detail provided on the basis of the calculations. IRRs for 2016 in the 2017 report ranged from -12 per

cent to 17 per cent and in many cases, they cannot be reconciled with the data presented in the report. It can be argued that the negative returns from the last three vintages are a function of the 'J-curve effect' (falling value initially followed by a recovery and rise) and performance will improve over time. The performance over the last decade does not support this view, however, and the trend in the vintages is strongly negative, indicating there are growing problems with the underlying performance.

These findings present an uncertain view on performance, yet overall it is clear that results are far below the original 20-30 per cent IRR target, and they indicate the opportunity cost and actual cost of the equity portfolio for the EBRD increased substantially in both absolute and relative terms over the last decade. Management has acknowledged the original cost of equity target of 20-30 per cent is no longer realistic and, in the 2017 report (internal, not published), it indicated that the target rate of return for future investments

will be 15 per cent per annum. This figure also appears unrealistic, however.

It is difficult to establish a market benchmark for the EBRD portfolio due to the limited presence of PEFs and listed companies in the EBRD's countries of operations, but evidence indicates its portfolio return was less than the market overall. Figure 14 shows that over the period 2004-16, in US dollar terms, the MSCI Emerging Markets Eastern Europe Index appreciated by about 30 per cent in absolute terms. Figure 15 shows the rolling compound annual growth rate for the index for 2004-16 averaged 10 per cent.

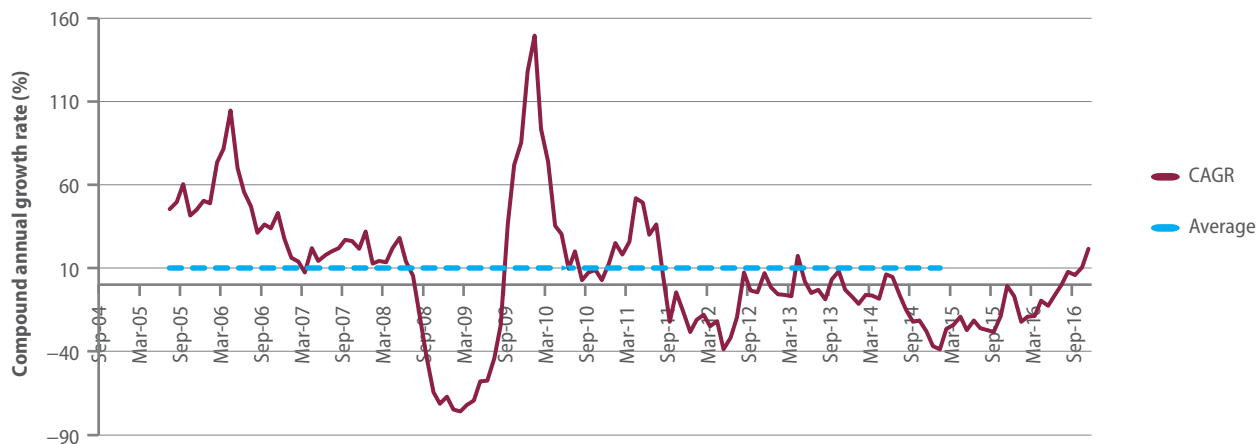
Figure 16 presents the EBRD's equity returns by region, up to the end of 2014. In the first vintage period, all of the regions were profitable. In the second period, central Europe and the Baltic states, and eastern Europe and Caucasus were profitable, and other regions were negative, with central Asia and Russia incurring the largest losses. This deterioration in performance was

**FIGURE 14. MSCI EMERGING MARKETS EASTERN EUROPE INDEX (US\$)**



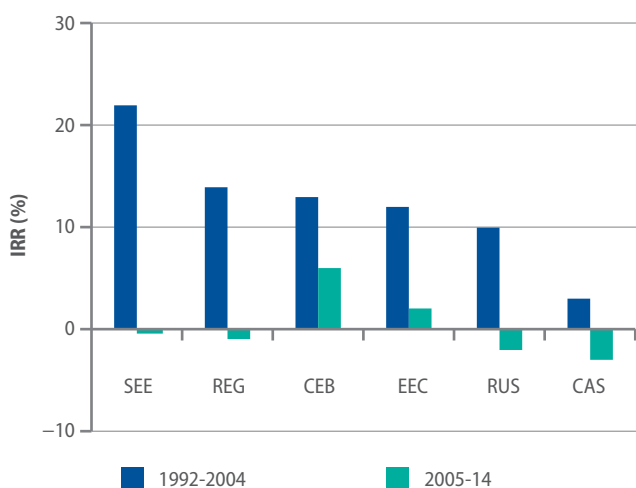
Source: MSCI (no date)

**FIGURE 15. MSCI EMERGING MARKETS EASTERN EUROPE (US\$): ROLLING COMPOUND ANNUAL GROWTH RATE**



Source: Data, MSCI; Chart, EvD

**FIGURE 16. EQUITY RETURNS BY REGION**



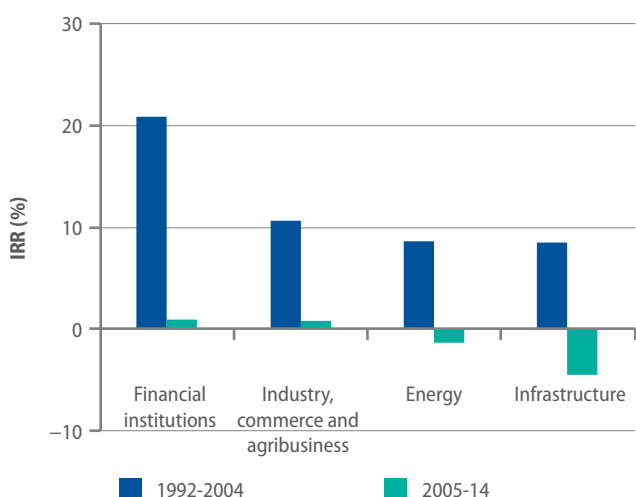
CAS = central Asia; CEB = central Europe and the Baltic states; EEC = eastern Europe and Caucasus; REG = regional; RUS = Russia; and SEE = South-eastern Europe.

Source: EBRD (2016b)

due to the global financial crisis, and political and macroeconomic events in Russia and Ukraine. Oil prices and a fall in the rouble of about 40 per cent in 2014 negatively affected equity markets in Russia and the surrounding regions. As a consequence, the EBRD's large Russian exposure – of 39 per cent of the portfolio by value at the start of 2014 – declined to 27 per cent by year end.

As Figure 17 shows, in the first vintage all sectors were profitable, particularly FI, whereas in the second vintage, energy and infrastructure generated losses. FI and industry, commerce and agribusiness were close to breaking even.

**FIGURE 17. EQUITY RETURNS BY SECTOR**



Source: EBRD (2016b)

The returns were updated by region and sector in 2017. These new data indicated returns had become positive in Russia (4.3 per cent), but continued to be negative in central Asia (-2.9 per cent), southern and eastern Mediterranean -9 per cent) and Turkey (-10 per cent), due to problems with investments in Cypriot and Greek banks, and depreciating currencies. Despite these difficulties, the FI current portfolio reported a return in 2016 of 3.5 per cent; energy recovered to 8.5 per cent, whereas infrastructure deteriorated further to -15.3 per cent.

Overall, performance in each period was very different, with substantial profits being generated in the first vintage by large privatisations of state banks in EU accession countries. In the second vintage, the largest gain was derived from an IPO in the industry, commerce and agribusiness sector in Russia, and the largest loss was from energy investments in Russia.

PEFs consistently outperformed direct equity. A background review of the equity portfolio provided by Management to the Board in 2015 (EBRD, 2015d) found that in addition to generating higher performance, PEFs demonstrated lower levels of volatility. The outperformance of PEFs is confirmed by the equity portfolio analysis (2017). This result was achieved despite a bias in the data towards direct equity, which does not reflect the EBRD's management costs. Management costs will be much greater for direct equity than for PEFs, as management fees are netted off by GPs before transferring returns back to the EBRD, and the internal administration costs of PEFs are minor.

**Evidence from other IFIs indicates management costs for direct equity are about double the operating costs for PEFs (IADB, 2017).**

Size was an important driver of performance. The EBRD got its best returns from investments in the range of €25-100 million. Investments below €10 million tended to perform poorly, and consumed excessive amounts of staff resources, as they were 64 per cent by number of deals, but only 8 per cent of the portfolio fair value. The type of investment had a large impact on return, with the EBRD's best returns coming from investments in direct equity in listed companies (EBRD, 2015d), and worst return from investing direct equity in unlisted companies – highlighting the critical impact of the exit mechanism on final returns.



# 4

## Implications for the EBRD's equity operations

## Results and key findings

- The EBRD's value creation plans for investments have not had a material impact on the EBRD's equity portfolio performance.
- The main drivers of performance in recent years have been macroeconomic instability impacting on countries and sectors, difficulties exiting from investments, the type of vehicle used to make the investment, and internal staff incentives.
- The establishment of the Equity Participation Fund in 2016 shifted the role of direct equity in the EBRD from being a project input to a stand-alone asset class, which requires clearly specified financial objectives and a management structure in accordance with its fiduciary duties.
- The EBRD needs a strategy to show how it will make effective and efficient use of capital and staff within countries of operations.
- The EBRD needs to articulate clearly its intended objectives in pursuing equity investments across sectors and countries, based on diagnostics that accurately reflect enabling environment conditions.
- The equity portfolio should be restructured to remove old investments that are no longer contributing to transition impact, or that are so small that the transition impact benefits do not outweigh costs.
- A specialised organisational structure and critical mass of staff and resources are required to enable the EBRD to be successful at investing, managing and divesting equity investments.
- Incentives for departments and staff need to be aligned with the EBRD objectives, using performance metrics that reflect the cost of carry of the capital allocated to the portfolio.
- Arrangements for reporting against strategic objectives to the Board need to be strengthened, with reviews of the Financial and Operations Committee and Audit Committee being informed by regular independent appraisals of the equity portfolio.

### 4.1. Overview

This section summarises the main drivers of the equity portfolio's performance, and reviews the implications and opportunities for improving performance, based on experience in the EBRD and other IFIs. This section draws upon the findings of EvD analysis, as well as various documents detailed in Appendix 3, in particular the IADB (2017) report.

### 4.2. Drivers of equity performance

The EBRD's contribution to value creation for shareholders through its support for business growth did not have had a material impact on the EBRD's equity portfolio performance in recent years. The main drivers of lower than expected equity portfolio performance

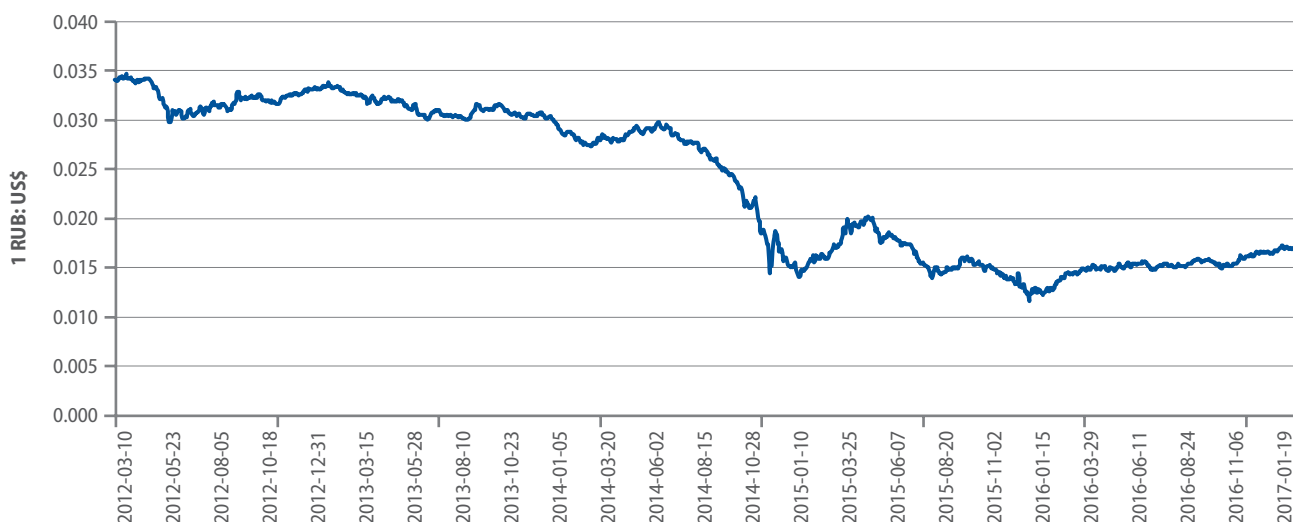
were: (a) macroeconomic instability at the country and sector levels; (b) weaknesses in the institutional environment for equity that make exits difficult; (c) the type of vehicle used to make the investment; and (d) internal staff incentives.

Changes in critical macroeconomic variables can be more than 50 per cent within a year, as shown by the trend in the rouble to dollar exchange rate (Figure 18), and the Russian stock market (ERUS) index (Figure 19). Our review of the EBRD equity portfolio indicated concentrations of large investments in FIs in a small number of countries (Greece, Russia and Turkey), and these have created large losses.

Infrastructure sectors are vulnerable to macroeconomic instability, due to the combination of sunk costs that make it difficult to adjust the scale of investments to

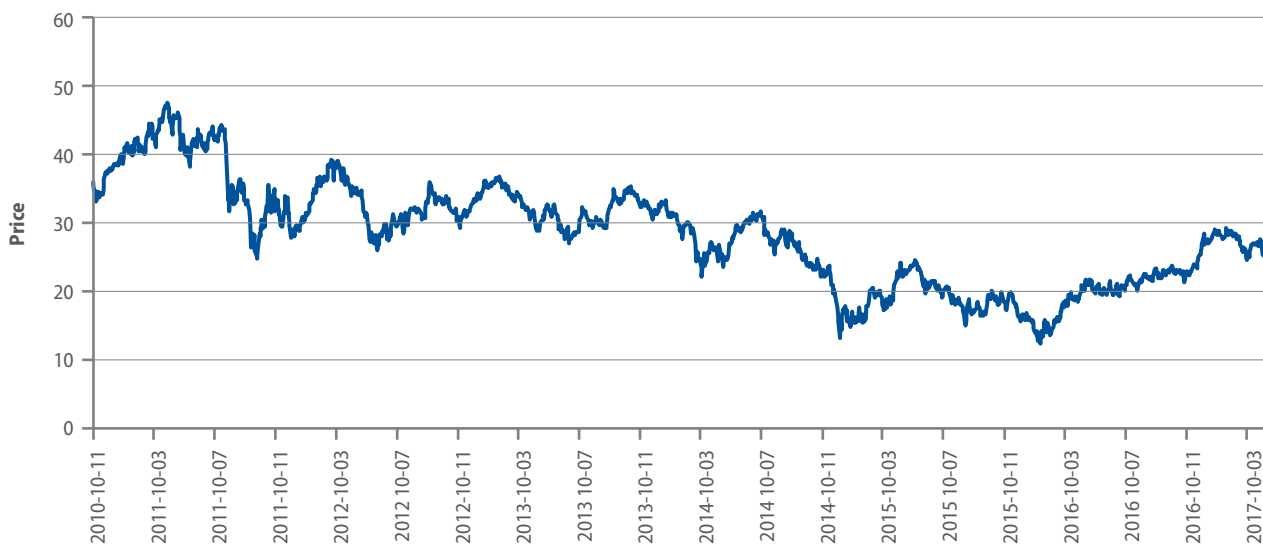


**FIGURE 18. RUB: US\$ EXCHANGE RATE, 2012-16**



Source: www.oander.com

**FIGURE 19. ERUS INDEX, 2010-16**



Source: Yahoo! Finance (<https://uk.finance.yahoo.com/quote/ERUS?p=ERUS>)

reflect the environment, and regulatory weaknesses where tariffs are not adjusted in accordance with changes in macro variables (e.g. exchange rates that impact on operating costs and debt servicing ability). These rigidities resulted in large losses in infrastructure industries, such as energy and transport.

While macroeconomic instability is a significant issue, the more critical systemic problems with the equity portfolio were derived from weaknesses in the enabling environment for equity, particularly for exits. PEFs can gain majority control of investments and design exits, whereas the EBRD can only take minority equity stakes and divest these interests to a third party. Many of the investments in the EBRD portfolio were based on the

assumption that it was possible to exit through an IPO or by using put options, but in practice these methods are not proving effective.

This is a concern as almost 77 per cent of the direct equity portfolio by fair value is invested in minority interests in relatively illiquid assets. Data provided by the EBRD Treasury indicates that about 18 per cent of its direct equity investments may be able to rely upon put options to exit minority interests. In theory, these put options create a floor on potential returns from equity. In practice, however, when a company is experiencing financial difficulties, other shareholders may not have the financial capacity to meet the terms of the put. An important feature of put options is the lack of collateral

attached to these instruments. As a result, there is a risk they may not be effective at recovering value.

The third most important factor contributing to equity returns was the type of investment vehicle, with PEFs tending to outperform direct equity by a substantial margin. This is a function of range of factors, including: (a) the ability to take majority ownership interests that provide a high degree of management control over value creation and exit; (b) high-powered incentives derived from carried interest that is linked to the achievement of actual financial returns; (c) adequate levels of resources that are scaled according to profit potential, rather than internal budget constraints; and (d) the ability to employ special purpose staff, with specialist technical skills to pursue specific measurable value-addition activities, often on a short-term basis, to achieve a particular goal.

The fourth critical factor was staff incentives, which are not designed to maximise transition impacts and financial returns on the EBRD invested equity capital. Projects with long time lines are subject to risks of 'optimism bias', and this is compounded by volume incentives and difficulties at project approval in verifying the amount of funding needed and the likely exit multiples. Staff mobility and long asset lives amplify these biases, as it is unlikely that the staff processing the transactions will be present, or accountable, when the EBRD exits.<sup>12</sup> These incentives also discourage exits from poorly performing investments. The recent establishment of the Equity Participation Fund, and the need to mobilise external funds based on expected results, are likely to compound further these perverse incentives to limit information flows.

## 4.3. Opportunities to enhance effectiveness and efficiency

### 4.3.1 Equity strategy

The EBRD is unusual amongst IFIs in that it does not have a strategy for equity. While most IFIs do not necessarily have a formal document setting out their strategy, they clearly define the role of equity within their business. The establishment of the Equity Participation Fund in 2016 shifted the role of direct equity within the EBRD, from being a project input to a stand-alone asset class. The EBRD is now managing

equity on behalf of third-party investors and it has a fiduciary responsibility to those investors. A strategy needs to be developed that shows how the EBRD will make effective and efficient use of capital and staff within countries of operations, and meet limited partner obligations.

An equity strategy could set out the key principles for:

- defining objectives
- identifying targeted regions, countries and sectors, stages of firm development and portfolio limits
- identifying the amount of available capital for equity at the country and sector levels
- defining the structure of the portfolio
- defining targets for transition impact and financial performance
- defining the organisational roles and responsibilities across departments, and use of country office staff for equity operations
- designing institutional structures and staff incentives
- managing and reporting on the performance of the overall portfolio.

### 4.3.2 Equity objectives

The evaluation of the equity portfolio did not find evidence of clear transition impact objectives that can be used as a basis for assessing effectiveness. The main justifications for equity were based on rationales such as the transfer of knowledge on good governance, equity investments being additional, and that transition impact and financial performance can be treated as synonymous under the heading of value creation. Objectives need to be based on something 'objective', however; something that can be measured, and change of a predetermined magnitude can be defined. Transfer of knowledge is too intangible and does not fall within this definition. Similarly, justifications based on additionality have largely occurred independent of an analysis of actual conditions on the ground within a country. This lack of analysis creates risks of large losses in circumstances where the EBRD has limited ability to mitigate the risks associated with weak institutions coupled with minority shareholdings.

<sup>12</sup> For a discussion on the causes of optimism bias, see: Flyvbjerg, Holm and Buhl (2002).

It can be argued that financial performance/value creation is a form of transition impact, but this objective has not been formally endorsed by the Bank, it runs contrary to its transition impact mandate, and it is unlikely to be feasible given the conditions in many of the EBRD countries of operations. More importantly, there is no reason why equity cannot be tightly linked to measurable transition impact indicators – such as improvements in the ability to list companies – that can be used to scale investments and measure performance.

### 4.3.3 Country and sector diagnostics

New country strategy frameworks provide an opportunity for the EBRD to strengthen its equity performance within countries, by providing more specificity on its actions. While it is difficult to be precise about the timing and scale of the EBRD's expected investments, the country strategy can identify constraints on the current portfolio, the adequacy of the enabling environment for equity, and actions that can be taken with governments to strengthen the environment and enable the increased use of complex instruments such as equity.

Country diagnostics can be used to develop strategies for equity that clearly identify how it will be used to strengthen transition impact. Proposed technical cooperation and investments within a country should reflect the environment for equity, based on factors such as:

- the quality of minority shareholder protection
- the ability to exit through capital markets
- the potential to proactively develop specific opportunities for equity investment in areas such as public–private partnerships in infrastructure.

Programmes can then be designed based on the capacity of existing institutions, available technical cooperation resources, and the government's willingness to borrow to help develop institutional capacity and create privately financed investment opportunities.

### 4.3.4 Availability of equity capital for new investments

The EBRD needs to define the level of equity and associated economic capital that it is willing to allocate to particular countries. Any allocation of capital to

equity implies at least 3.5 times less capital available for debt operations (and its associated revenues), and the scale of equity programmes within countries should reflect these risk-return parameters. Given the sensitivity of portfolio performance to macroeconomic events and opportunities for reducing risk through diversification, there is a need to revisit the country and sector limits of 30-35 per cent presented in the Enhanced Equity Approach, which are too high.

### 4.3.5 Portfolio structure and required returns

One of the primary decisions in an equity strategy is the balance between indirect investments through PEFs and direct investments in equity. Investments through PEFs outsource the selection and management of investments to third-party managers, at the cost of relinquishing control over the selection of investees and the payment of fees to fund managers. IFIs such as the Commonwealth Development Corporation have often used PEFs as a way to gain an exposure to equity and an understanding about how direct equity works within countries and sectors. Direct equity provides more control over the selection of investees, but it requires greater internal capacity, incurs higher operating costs and has greater variability in returns. Exit multiples are a primary determinant of performance. Traditional exits such as IPOs and put options have not proved to be effective mechanisms to protect value. Hybrid instruments such as mezzanine debt provide an alternative that can be used as 'pathfinder' instruments for follow-on equity investments. Hybrid financing instruments will have much lower operating and capital costs than direct equity and PEFs.

The scale of investments is an important determinant of performance, as staff requirements tend to be driven by the number of projects rather than the individual size of projects. This phenomenon indicates opportunities for economies of scale, suggesting that sectors such as infrastructure, which generate large-scale projects, should be a high priority.

The stage of investment is a critical factor when designing the portfolio structure. Companies that are past the high-risk, early start-up stage, and are seeking to grow, provide opportunities for diversification to reduce risk and achieve savings. The term of investments will be critical, as in most cases transition impacts will be achieved within a fairly short period (3-4 years) and, once attained, equity should be divested so it can be recycled into new transition impact initiatives.

The review of the existing equity portfolio indicates there are a large number of investments that could be divested to improve performance. In 2016, there were 77 investments that were 7 or more years old, and about 63 per cent of the historical portfolio by number was less than €10 million.

When considering different investment opportunities, comparisons between debt, mezzanine finance, PEFs, options and direct equity, across various scales, scope and timing dimensions, need to be fully costed. IFI comparators indicate that administrative costs for equity can be twice as high as for debt. Specific provisions should be included in project appraisals to avoid optimism bias and fully reflect a minority shareholder discount on the purchase price of equity.<sup>13</sup>

#### **4.3.6 Organisational arrangements and staffing**

Investments in PEFs require access to fund managers and knowledge of fund structuring, rather than a large international network. Approval processes need to enable rapid responses and it may require delegated authorities to meet market deadlines. Most IFIs use separate teams to invest in PEFs, as this expertise is specialised and internal investment requirements are minimal, as the primary management functions are screening PEF investments opportunities and oversight of the GP.

By comparison, the sourcing of direct equity investments requires a large local network within countries and a critical mass of sector expertise. Specialist staff are needed to manage equity, who focus on realising upside potential rather than the debt focus of mitigating potential losses. Equity requires continuous attention to investments to identify opportunities to adapt to create value, rather than rely on loan covenants to protect value.

Most IFIs use multi-sector teams to carry out the origination process for direct equity. There is an organisational choice to make regarding this function: (a) leave responsibility for value addition with the staff who originated the transactions; or (b) hand operations to different staff who are only responsible for monitoring investments. The first approach retains the staff who know the most about the investees and helps build longer-term relationships. The disadvantage

is that Bank origination staff tend to be driven by new business volume incentives, detracting from their ability to work continuously with existing investees.

The EBRD has developed a compromise where bankers are incentivised to originate equity investments, whereas the Equity Group is allowed to participate in this origination process. This structure can only work effectively if the Equity Group and the Equity Risk Areas team are given the right to veto equity proposals, and they are made accountable for the performance of the equity portfolio. An important corollary of this requirement is the need for adequate resources for due diligence and administration of the equity portfolio. A further requirement is that the Equity Group is given control of all current and future equity operations, including the small regional funds in the Direct Financing Facility, and is made subject to the same oversight arrangements as other equity investments. It may be necessary to create a matrix organisation structure, where selected staff in country offices also report to the Equity Group.

Staff responsibilities during the operating period need to be carefully defined, differentiating between the roles of the bank relationship managers, board representatives and equity portfolio managers. The role of the board directors needs to be assessed in the context of a portfolio review, to identify opportunities to reduce the number, tighten their focus to implement value creation plans and link exits to the achievement of transition impacts. In many cases, the EBRD will have limited voice, due to minority shareholder status or lack of specific knowledge; in these circumstances, a position on the board should not be required.

A key operating decision is whether investments are divested by originating departments, or transferred to a 'divestment unit' whose sole responsibility is obtaining the best value while ensuring proper compliance with regulations (e.g. not using 'insider' – material, non-public – information). A process may need to be established to deal with impaired assets, as direct equity investments do not auto-liquidate (like PEFs) and can create potential liabilities such as site clean-ups and staff redundancies following closure. As a result, the 'value' of an equity investment can potentially be negative, and expose the EBRD to significant reputational risks, indicating that resources need to be budgeted for this purpose. The amount of resources could be significant if the EBRD actively restructured its existing portfolio to divest non-performing assets.

<sup>13</sup> Examples of these types of procedures can be found in HM Treasury (2013).

Equity can generate large losses, and potential options to mitigate this risk in the future include ring-fencing equity operations by establishing a separate funding pool. There is also a need to decide on whether to mobilise co-investment resources from third parties. Institutional arrangements have ranged from specialist operations, such as the Asset Management Company established in the IFC as a subsidiary, through to the EBRD hybrid debt and equity structure that relies on specialist support services, provided by the Equity Group, to its core banking operations. Given the difficulties of funding the Equity Participation Fund, compared with the Asset Management Company, which manages about US\$9.0 billion, there is a case for considering the potential to: (a) offer limited partners opt-out clauses; (b) ring-fence the funds allocated to equity; (c) introduce a carried interest charge to finance equity operations to incentivise departments to divest equity that is no longer generating transition impact and financial returns; (d) create a subsidiary along the lines of the Asset Management Company; and/or (e) invest in majority rather than minority equity participations.

#### **4.3.7 Staff incentives**

Staff incentives need to be linked to the expected transition impact and financial returns from investment. Long project lives, a lack of information and high staff mobility make it difficult to address this issue. Objective criteria, in the form of specific project milestones that are established before project approval, are required to trigger the equity exit process for each investment.

The IFC has introduced a carried interest charge for departments to reflect the cost of keeping equity and encourage exits from mature investments. The IFC has also introduced a system to link staff compensation to equity performance in the Asset Management Company. This system rewards staff for a fund's performance using a carried interest remuneration system similar to PEFs; the EBRD should consider introducing this system.

#### **4.3.8 Reporting arrangements**

Equity requires a higher level of objective accounting and reporting standards than debt. While accounting standards allow some investments to be carried at cost, effective management of equity requires each investment to be assessed regularly (usually quarterly) on a fair value basis. At a minimum, reviews should include internal and external audits, using defined and consistently applied valuation methodologies for variables such as fair value and the costs of originating and administering equity. The annual equity portfolio performance appraisal should form part of the Financial and Operations Committee deliberations on the equity structure and operations. Comparator IFIs highlight the importance of objective reports by requiring independent reviews of performance at regular intervals. In the context of the EBRD, this need for objectivity and transparency has been heightened by the establishment of the Equity Participation Fund and the need to attract external capital from limited partners.



# 5

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