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Independent Evaluation of Bank Group Equity Investments Summary Evaluation Report

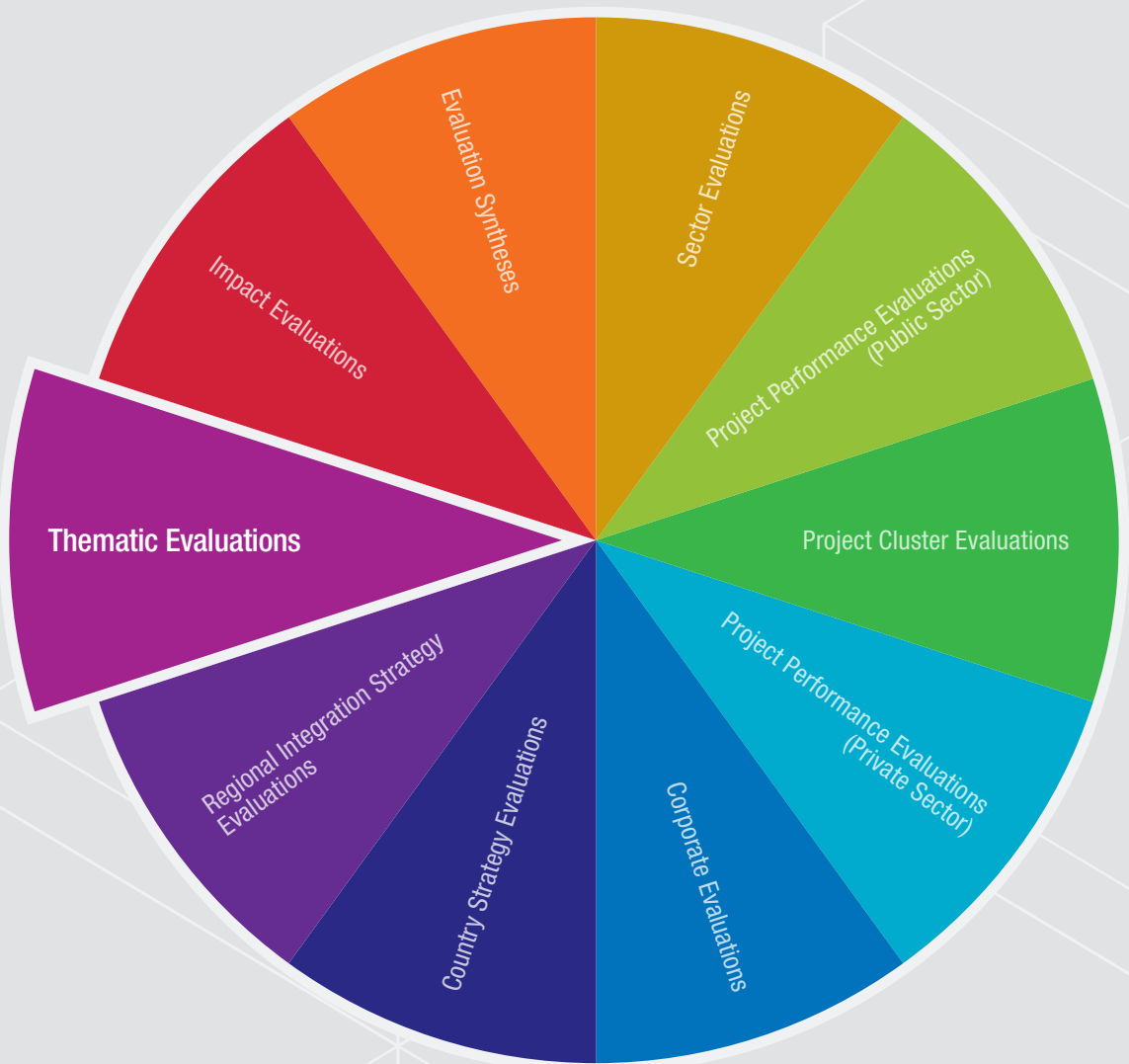
Executive Summary



AFRICAN DEVELOPMENT BANK GROUP

October 2015

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Executive Summary

Introduction and Evaluation Approach

This report presents the findings of an evaluation of the Bank Group's Equity Investments. This evaluation was conducted in order to inform Bank's decisions on the future use of equity investments by identifying lessons and potential areas for improvement. As such, the purpose of the evaluation is two-fold: 1) assess the relevance and performance of the Bank's equity investments; and 2) identify lessons, recommendations and areas for improvement.

The evaluation covers the combined fund and direct investments in the equity portfolio, which represent capital commitments of UA 740M and disbursements of UA 475M (64%) of capital commitments.

Several data collection methods were used. These included a literature review on the latest trends and issues related to equity investments in Africa, a thorough portfolio and program review to assess trends, measure risk, and complete bottom-up cash flow projections to support pacing and liquidity analysis, a survey of all fund managers, field visits to a sample of projects to collect development outcomes (DO) indicators, a financial database sourced from quarterly and audited financial statements of the funds partnership, and a benchmarking analysis comparing the Bank's portfolio with a customized private equity fund focused on Africa and with relevant benchmarks of public market securities.

Evaluation Findings

Relevance: Alignment with the Bank's Strategy and Priorities

Relevance was rated satisfactory. The majority of the Bank's equity investments (both private equity and direct investments) are aligned with its industrial objectives and priorities. In addition, the investments adequately support regional diversification, regional integration, Micro Enterprises, Small and Medium Enterprises (MSMEs), and fragile states to a lesser extent (for equity funds).

Equity investments were assessed in terms of their alignment with the Bank's key sectors, regional diversification, regional integration, support of MSME¹ and fragile states:

- Industry analysis for the fund portfolio shows adequate alignment between actual funds investee cost basis and the Bank's priorities, particularly with regard to infrastructure. However, a sizeable proportion (14%) of the funds are not clearly aligned with Bank priorities. In addition, all direct investees are financial institutions, which directly supports the Bank's strategy of developing soft infrastructure.
- The equity funds have invested capital in companies across 35 countries, demonstrating a high level of regional diversification. Pan-African funds, the largest category, represents companies that operate across several countries. However, a substantial proportion of the investments (25%) was concentrated in only two countries – Nigeria and South Africa. With respect to direct investments, regional diversification is adequate, with investees headquartered in 12 countries.

Three companies headquartered in Nigeria have received 29% of disbursements, followed by four companies in Kenya with 19% of disbursements. In addition, many direct investees operate and have branches in several countries, further diversifying the portfolio.

- The Bank's equity investments in infrastructure and in a high number of countries are likely to promote regional integration. In addition, the direct investments portfolio is well aligned with the Bank's priorities of promoting regional economic integration. Twelve investees have operations in multiple countries, representing 89% of the disbursed capital. Some of these companies specifically seek to increase African trade, while others are financial institutions operating in several regions.
- Actual fund investee cost-basis is adequately aligned with the Bank's objectives of supporting MSMEs. Approximately 34% of the capital has been invested in MSMEs while 52% has been invested in Large Enterprises (LE). This is due in part to the fact that larger enterprises naturally require larger equity investments compared to MSMEs. Investee companies included 462 MSMEs (with an approximate average investment of UA 216,000) and 52 large enterprises (with an average investment of UA 2.9 million). With respect to the direct investments portfolio, 15 of the 19 investees (representing 60% of disbursed capital) are MFIs and DFIs, which would be expected to benefit MSMEs. On the other hand, MSMEs comprise only a small portion of direct investees. This is to be expected, as a large portfolio of small direct investments would be resource-intensive.
- Only 10% (UA 27 million) of the total fund investee cost-basis has been invested in companies operating in fragile states. This is unsurprising as fragile states are less attractive to many private equity managers given that they often have less-developed institutional frameworks, weaker governance, and experience social conflict. However, considering the Bank's

low-income country and fragile states country limits for the private sector, this breakdown achieved via funds is higher than the overall private sector department financing.² Seven of the direct investees (22% of all disbursed capital) are headquartered in fragile states, and another four are known to have branches in fragile states (38% of disbursed capital); a substantial proportion of disbursements goes directly to investees operating in fragile states.

Performance: Financial Performance and Effectiveness

Overall, the performance of the Bank's equity investments has been rated moderately satisfactory, based on the assessment of financial performance and the effectiveness of equity investments. Financial performance was rated satisfactory as the majority of mature funds are in the first quartile compared to their benchmarks. Results for more recent funds were mixed, but the majority were lagging behind their benchmarks. It is too early, however, to make a definitive judgement on the more recent funds, which are still at early stages of the J-curve. Effectiveness (i.e., outcomes' achievement) was rated as moderately unsatisfactory because: 1) a substantial proportion of funds were behind in their plans or did not meet their targets on two key outcomes (job creation and tax revenues) and, 2) there was a lack of reliable outcomes data, particularly on direct investments. That said, it is still too early to make a final assessment of these results and the Bank has sufficient time to catch up on its targets.

Financial Performance

Since 2007, the Bank has experienced a rapid consumption of risk capital, leaving only a modest proportion (38%) of the 15% limit to be used until 2020.

Fund investments are immature, and several years away from liquidity: 1) more than half of the commitments are at an early stage (fundraising and investment); 2) the majority of funds have inception dates later than 2008, and 3) the weighted average age of underlying companies is lower than the typical private equity company holding periods.

Compared to their vintage year benchmarks (both the general universe and Custom Benchmark for Africa), the majority of mature growth funds performed well. However, the eight private equity funds (2008 and 2009 vintages) all had total value multiples that trailed the pooled averages of the broader universe of emerging markets funds. The picture is slightly better when compared to the Custom Benchmark for Africa, where two of the eight are ahead of their comparators. Most of the value of funds from 2008 vintage onwards is held in unrealized investments.

Investments in key sectors such as Information Technology (IRR: 37.1%), Financial Services (IRR: 14.2%), Manufacturing (IRR 19.5%), and Transportation (IRR: 10.4%) had the strongest performance. Health Care (IRR: 23.9%) and Industrial (IRR: 35.5%), which accounted for a small amount of capital, also had strong performance. Consumer/Retail (IRR: 5.4%), Energy: Upstream/Royalty (IRR: 5.4%), Construction (IRR: 0.3%), and Timber (IRR: 1.8%) lagged with modest rates of return.

Effectiveness

The Bank's funds are generally lagging behind their targets for job creation, and a sizeable proportion of committed capital did not meet its Tax Revenue Generation targets:

I Early results data are partial but indicate that the majority of the Bank's equity funds are either behind their plan or missing their job creation targets. Only 19% of the evaluated committed capital was invested in funds considered ahead of plan, while the remaining capital was committed to funds considered behind plan (53%) or that have failed to meet the targeted outcomes (28%). While results data for job creation for women are more positive than the overall job creation numbers, they are still far behind target. About 57% of the evaluated committed capital was invested in funds considered on or ahead of plan in terms of job creation for women, while the remaining capital (43%) was committed to funds considered behind plan.

I While the majority of evaluated committed capital was on plan to meet their targets for tax revenue generation, a sizeable proportion of evaluated committed capital did not meet its targets. About 65% of the evaluated committed capital was invested in funds considered on or ahead of plan in terms of annual tax revenue generation, while the remaining capital was committed to funds considered behind plan (12%) or that did not achieve their targets (23%).

On the positive side, the Bank's equity funds performed well with respect to environmental plans. The majority of capital is invested in companies that either had or had added environmental mitigation plans (EMPs). About 31% of the evaluated company cost-basis was invested in companies that had added EMPs post-investment. An additional 27% of the capital was in companies that already had EMPs in place at the time of investment. About 13% of the capital was invested in companies that have not yet added EMP plans, but these may be in industries that are not expected to have negative environmental impacts and therefore may not require such plans.

The Bank has played a catalytic role in mobilizing additional resources for private equity, particularly in

sub-Saharan Africa. However, the level of the Bank's additionality is limited in Middle-income countries such as South Africa, which has the potential of raising sufficient funds without Bank assistance. Moreover, as a limited partner and adviser, the Bank may be missing an opportunity to play an active role in the management of equity funds and influence investment decisions.

Risk Management

The overall risk rating of the equity portfolio has not changed on a weighted-average basis. However, subsequent to enhanced models, the fund portfolio's risk rating was downgraded slightly from 5+ to 5. By contrast, the direct investment portfolio was upgraded from 5+ to 4+. Over 80% of investments by value have experienced a change in ratings since appraisal, indicating a significant change in the Bank's understanding of each investment's risk profile since appraisal.

It is important to maintain a consistent commitment pace and not over- or under-invest in certain vintage years. The inconsistent commitments to the asset class year-to-year make reliable cash flow forecasting even more critical, as it is an important aspect of effective private equity portfolio management. As indicated above, the Bank has set an equity limit of 15% for the portfolio calculated based on total risk capital³. As a result of significant investments made during 2008, and to a lesser extent, in 2010 and 2011, the risk capital utilization rate is quickly approaching this limit. In response to concerns among internal and external stakeholders alike, the Bank has dramatically reduced the overall pace of its commitment year-over-year since 2011. A better understanding of expected future capital calls and distributions for fund investments is critical to the future commitment and active portfolio management decision-making process.

The scope of the evaluation study did not include assessing the adequacy of the Bank's risk methodology. However, a number of stakeholders have raised some noteworthy concerns to the Bank's risk methodology and its application.

Recommendations

Recommendation 1: Continue investments in private equity funds and further strengthen portfolio oversight and management.

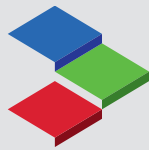
Recommendation 2: Develop and implement a multi-pronged investment strategy that would allow for an approach that responds to the Bank's diverse priorities and strategic objectives, by for example, establishing two investment streams: 1) a core portfolio that would focus on making larger investments supporting established fund managers with proven track records and a history of making investments that align with the Bank's priorities and, 2) a second higher-risk sub-portfolio that would focus on making smaller investments supporting first-time managers with strategic objectives related to fragile states or SME focus.

Recommendation 3: Review the risk capital limit of 15% risk and/or develop and implement an effective exit strategy for some of the older investments to free up capital.

Recommendation 4: Conduct a detailed, rigorous cash flow projection exercise.

Recommendation 5: Review the Bank's Risk Management methodology in light of concerns raised by several stakeholders.

Recommendation 6: Develop and implement a results-based management strategy to ensure 1) a streamlined, strengthened monitoring system of equity investments and, 2) a rigorous development outcomes tracking system.



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About this Evaluation

This assessment summarizes the findings from an evaluation of the African Development Bank Group's Equity Investments. The evaluation triangulates data from a number of sources, including but not limited to a portfolio and program review, a survey of all fund managers, field visits to targeted projects, a review of quarterly and audited financial statements of the funds partnership, and a benchmarking analysis. The portfolio assessed comprised both combined funds and direct investments in the equity portfolio. The assessment confirmed that the equity investments are aligned with the Bank's strategic priorities; although by their nature, fund investments focus on higher return and lower risk countries, and therefore benefits to fragile states and micro, small and medium enterprises are limited.

About the African Development Bank Group (AfDB)

The overarching objective of the African Development Bank Group is to spur sustainable economic development and social progress in its regional member countries (RMCs), thus contributing to poverty reduction. The Bank Group achieves this objective by mobilizing and allocating resources for investment in RMCs; and providing policy advice and technical assistance to support development efforts.

The mission of **Independent Development Evaluation (IDEV)** is to enhance the development effectiveness of AfDB initiatives in its regional member countries through independent and instrumental evaluations and partnerships for sharing knowledge.



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