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Independent Evaluation of Bank Group Equity Investments

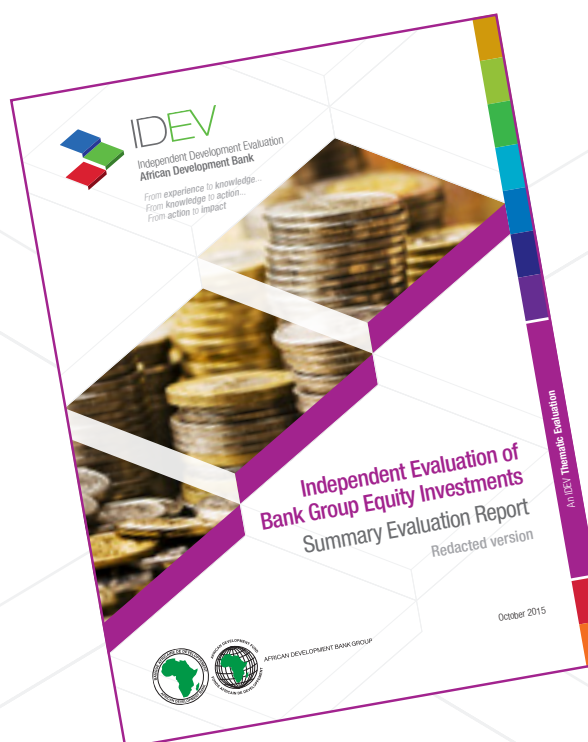
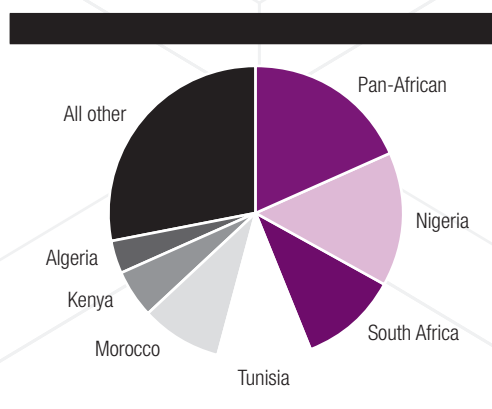
Objective, Scope and Approach

The overall objective of this evaluation is to inform Bank's decisions on the future use of equity investments by identifying lessons and potential areas for improvement. To this end, 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 on 31 December 2013 represented capital commitments of UA 740M and disbursements of UA 475M (64%) of capital commitments.

The evaluation triangulated data from several sources, including a literature review; a thorough portfolio and program review; a survey of all fund managers; field visits to a sample of projects; 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.

Regional diversification, Fund Investee Cost Basis



AFRICAN DEVELOPMENT BANK GROUP

Combined fund and direct investments in AfDB equity portfolio (as of 31 Dec. 2013), in million UA

Investment Type	#	Commitments	Disbursed	Callable	Distributed	Current Value
Fund	31	537.0	333.2	203.8	61.4	290.2
Direct	19	202.5	141.4	61.1	0.0	184.5
Total	50	739.5	474.6	264.9	61.4	474.7

Main Findings

Relevance: Alignment with the Bank's Strategy and Priorities

Relevance was deemed satisfactory. The Bank's private equity investments are well aligned with its industry objectives, as more than 80% of investee cost basis are in industries that the Bank supports. Both hard and soft infrastructure companies are well represented, followed by natural resources and agriculture companies. With respect to fragility, while the fund is not heavily invested in fragile states, the exposure achieved indirectly exceeds the overall private sector department financing. Direct investments are also aligned with Bank priorities including developing soft infrastructure, diversification, fragility, and regional integration.

- While the majority of investments are adequately aligned with the Bank's priority sectors, a sizeable proportion (14%) of investments have no clear alignment with Bank priorities.
- The equity funds have invested capital in companies across 35 countries, highlighting a high level of regional diversification. However, one quarter of equity investments are concentrated in only two countries: Nigeria and South Africa. With respect to direct investments, regional diversification is adequate, with investees headquartered in 12 countries.
- The AfDB's equity investments in infrastructure in a large number of countries are likely to promote regional integration.
- The analysis demonstrates an adequate degree of alignment between actual fund investee cost basis and the stated objectives of supporting micro, small and medium enterprises (MSMEs). Roughly 34% of the capital has been invested in MSMEs while 52% has been invested in Large Enterprises.
- Only 10% (UA 27 million) of the total fund investee cost-basis has been capitalized in companies operating in fragile states, since these nations are less attractive to many private equity managers due to less-developed institutional frameworks, weaker governance, and social conflict. That said, considering the Bank's low-income country and fragile states limits for the private sector, the breakdown achieved via funds is higher than the overall private sector department financing.

Performance: Financial Performance and Effectiveness

The overall performance of the AfDB's equity investments is deemed moderately satisfactory.

- Financial performance was rated satisfactory.** The mature growth equity funds have performed well, with three out of five in the first quartile. The less mature funds had mixed results, but were generally lagging behind their benchmarks for financial performance. However, it is too early to make a definitive judgement on the more recent funds as they are still at an early stage.
- Effectiveness (i.e. achievement of development outcomes) is moderately unsatisfactory** because: 1) a substantial proportion of funds were behind in their plans or did not meet their targets on job creation and tax revenue generation; and 2) there is a dearth of reliable outcomes data, particularly on direct investments. However, it is still too early to make a final assessment of these results, as the funds still have time to meet their anticipated targets.

A positive note is that the Bank's equity funds performed well with respect to environmental plans. Furthermore, the Bank played a catalytic role in mobilizing additional resources for private equity, particularly in sub-Saharan Africa. That said, the level of the Bank's additionality is limited in middle-income countries with the capacity to raise adequate resources without Bank assistance.

Risk Management

The overall risk rating of the equity portfolio has generally not changed on a weighted-average basis. That said, subsequent to enhanced models, the fund portfolio's risk rating was downgraded slightly from 5+ to 5. On the other hand, the direct investment portfolio was upgraded from 5+ to 4+. Also, over 80% of investments by value experienced changes in their rating after appraisal – highlighting a significant change in the Bank's understanding of each investment's risk profile post-appraisal.

In response to concerns raised by its stakeholders (internal and external), the Bank dramatically scaled-back the pace of its year-to-year commitment post-2011

While the evaluation did not explicitly assess the adequacy of the Bank's risk methodology, a number of stakeholders raised some concerns about the Bank's risk methodology and its application.

Weighted-Average Portfolio Risk Rating, using Bank capital account information and risk ratings

	Rating at Appraisal (Based on Commitments)						WA Portfolio Rating
	Very Low Risk	Low Risk	Moderate Risk	High Risk	Very High Risk	NA	
Funds	0%	0%	75%	25%	0%	0%	5+
Directs	6%	25%	33%	31%	0%	4%	5+
Total	2%	7%	64%	26%	0%	1%	5+

	Current Rating (Based on Exposure)						WA Portfolio Rating
	Very Low Risk	Low Risk	Moderate Risk	High Risk	Very High Risk	NA	
Funds	0%	5%	53%	39%	3%	0%	5
Directs	23%	21%	43%	13%	0%	0%	4+
Total	8%	11%	50%	30%	2%	0%	5+

Conclusion

The evaluation demonstrated that equity investments are aligned with the Bank's strategic priorities. Also, the financial performance of the equity investments, particularly for mature funds, is satisfactory. Furthermore investment helps diversify the Bank's investment strategy; and is an attractive way to access private markets, because it is less risky than direct investment.

Recommendations

- Continue investments in private equity funds and further strengthen portfolio oversight and management.** To this end, the Bank could consider the following:
 - Undertake a full or partial sale of the portfolio.
 - Maintain management in-house so as to retain and develop institutional knowledge, and build expertise while maintaining full control of the portfolio. However, the Bank would need to dedicate and/or hire the appropriate internal resources.
 - Fully outsource portfolio management to allow the Bank to benefit from outside expertise and significantly reduce the administrative burden of managing the portfolio. Doing so, however, may impede the Bank's ability to develop internal expertise and cause it to lose a measure of control over the ultimate direction of the portfolio.
- Partially outsource portfolio management** such that the Bank maintains institutional knowledge and control of the portfolio, but frees up internal resources to focus on the most critical components of the investment process.
- Develop and implement a multi-pronged investment strategy 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.
- Review the risk capital limit of 15% and/or develop and implement an effective exit strategy** for some of the older investments to free up capital.
- Conduct a detailed cash flow projection exercise.**
- Review the AfDB's risk management methodology** in light of concerns voiced by a number of stakeholders.
- 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.

About IDEV

Independent Development Evaluation (IDEV) of the African Development Bank carries out independent evaluations of Bank operations, policies and strategies, working across projects, sectors, themes, regions, and countries. By conducting independent evaluations and proactively sharing best practice, IDEV ensures that the Bank and its stakeholders learn from past experience and plan and deliver development activities to the highest possible standards.

Management Response

Management welcomes IDEV's evaluation of the AfDB's private equity portfolio, which presents a fairly positive view of the Bank's interventions. The evaluation is timely, as Management is reviewing some of the Bank's systems for building and managing the portfolio. The portfolio has reached a level of maturity that allows a number of conclusions to be drawn on its performance. These conclusions will inform the Management Framework for Equity that is currently being prepared. Overall, Management agrees with most of the findings and recommendations of the evaluation, while providing clarifications on issues where it has reservations.

The evaluation provided valuable recommendations, many of which are in line with recent Management actions. The Bank was already preparing documents that respond to the recommendations:

- The Revised Non-Sovereign Operations (NSO) Policy, with provisions superseding the 1995 Equity Policy (distributed on 3 July 2015 for CODE discussion);
- The first Annual Management Equity Status Report, and
- A Management Framework for Equity Portfolio Construction and Management, intended to formally integrate the lessons from the last decade of equity investing and inform the strategic direction of the Private Sector Development and Financial Sector Development Strategies.

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