OVE Office of Evaluation and Oversight

Approach Paper

Comparative Study of Equity Investing in Development Finance Institutions

IDB Inter-American Development Bank

IIC Inter-American Investment Corporation
A Member of the IDB Group

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ACRONYMS AND ABBREVIATIONS

CAF	Corporación Andina de Fomento
CDC	Commonwealth Development Corporation
DEG	German Investment Corporation
DFI	Development Finance Institution
E&S	Environmental and Social
EBRD	European Bank for Reconstruction and Development
EMPEA	Emerging Markets Private Equity Association
FMO	Netherlands Development Finance Company
GIIN	Global Impact Investing Network
IDB	Inter-American Development Bank
IDBG	Inter-American Development Bank Group
IFC	International Finance Corporation
IIC	Inter-American Investment Corporation
KNL	Knowledge and Learning Department
LAC	Latin America and the Caribbean
LAVCA	Latin America Private Equity and Venture Capital Association
MENA	Middle East and North Africa
MIF	Multilateral Investment Fund
OPIC	Overseas Private Investment Corporation
OVE	Office of Evaluation and Oversight
PE	Private Equity
ROE	Return On Equity
SEAF	Small Enterprise Assistance Funds
SG	Sovereign Guaranteed
SME	Small and Medium-Sized Enterprise
TA	Technical Assistance
VC	Venture Capital

I. CONTEXT

1.1 **The IIC Board of Executive Directors mandated OVE to produce a technical study to inform IIC's future equity business.** In January 2016, the private sector activities of the IDB Group were combined into an expanded IIC, which was recapitalized, absorbing personnel and responsibilities over all non-sovereign guaranteed operations of the IDB and the existing IIC, including equity investments. In this context the IIC's Board approved a business plan contemplating equity investments over the next ten years. The Board expressed interest in supporting IIC's new equity strategy and investments with a technical study by OVE focusing prospectively on what the IIC could learn from its own experience and from that of other DFIs. Rather than being a full evaluation of IIC's past experience, the study –for which this Approach Paper defines key questions and methods– aims at supporting IIC's equity investing going forward.

1.2 **Within IDBG, only IIC and the Multilateral Investment Fund (MIF) pursue equity investing, but unlike MIF's, IIC's equity operations have not yet been comprehensively evaluated.** As per its establishing agreement, IDB cannot invest in equity. By contrast, IIC is allowed to do equity investments, having approved 132 equity operations totaling almost US$450 million since its creation in 1989. Similarly, MIF approved 146 equity operations amounting to US$500 million. MIF's equity operations were recently reviewed in two evaluations by external consultants (Dalberg)[1] and OVE[2] (Box 1.1). MIF will not be the study's focus, but OVE will consider MIF's equity experience whenever it is a relevant comparator for IIC.

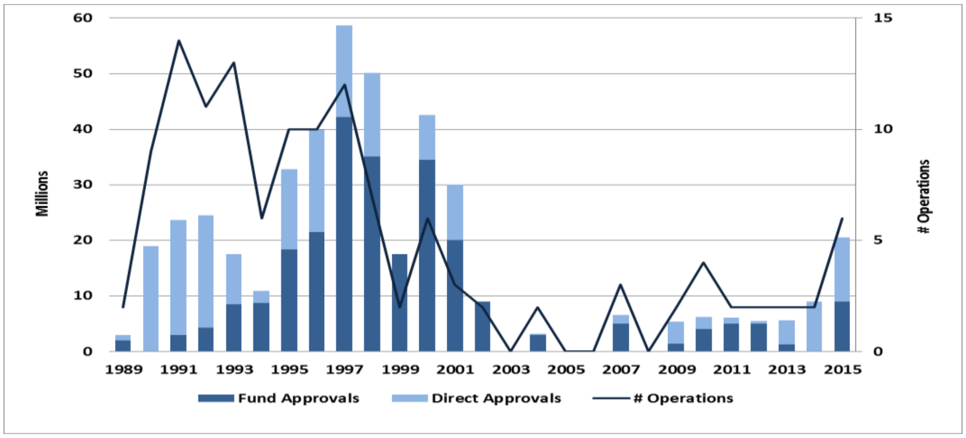
> **Box 1.1: Findings from previous MIF evaluations**
>
> **Dalberg (2012)** was retained to assess MIF's venture capital investments and their contributions to development. With some methodological caveats, the study found on average a 23% annual increase in revenue and a 13% annual increase in employment by venture capital-backed companies during the 5.2 year average investing period.
>
> **OVE (2013)** conducted a comprehensive independent evaluation of MIF, including its venture capital operations. It found that MIF had been highly relevant and successful in the area of venture capital and early equity, and it was able to leverage increased amounts of fund and produce sustained impact in venture capital. But the evaluation also identified challenges to observe results of projects due to long investment periods and insufficient data collection.

1.3 **Although IIC has invested in equity since its establishment over 30 years ago, equity volumes were limited over the past ten years**. Historically, equity played a larger role in IIC, peaking at almost US$60 million annual approval volume in 1997. However, in the early 2000s, IIC faced significant write-downs due to a high concentration of investments in funds managed by general partners with insufficient experience in the region. At that time, IIC's equity operations stopped for about five years, following the recommendation of an external review panel focused on maintaining IIC's financial viability. As a result, IIC missed the ensuing rebound of LAC's equity market. IIC slowly returned to equity investing in 2009 –helped in part by the new China Fund– but with limited investments of around US$5-6 million annually. Only in 2015 did equity approvals exceed US$20 million, signaling IIC's interest in reengaging in the equity business.

[1] Assessing the impact of MIF's venture capital program in Latin America, Dalberg, 2012.

[2] The role of venture capital in financing innovation: A review, with special attention to LAC, OVE 2013.

Figure 1.1: IIC equity investment volumes were limited over the past ten years



Source: OVE based on IDBG internal data

1.4 **Equity investing centers around the buying of ownership (or quasi-ownership) stakes in businesses.** There are three main types of equity investments. *Seed funding* provides financing at very early stages. *Venture capital* (VC) also involves early stage entry, but unlike seed funding VC is often accompanied by management and networking support. Finally, *private equity* (PE) covers later stages by providing capital and support to existing businesses, up until the listing of their shares in public capital markets or their private sale to other investors. PE is not subject to the same level of regulatory scrutiny as stock offerings to the general public, but is also far less liquid. PE investing targets businesses that are either ripe for expansion or whose value is under-optimized. PE investments are further differentiated according to the key objectives pursued (Table 1.1). This study will center on PE, because this is likely to be IIC's focus.[3]

Table 1.1: Types of private equity investments

Types		Description
Seed Funding		• Typically individuals investing their own funds • High risk (usually in startups), but also high potential returns
Venture Capital		• Typically funds pooling resources from (institutional) investors • Often follows angel investment to help investee companies grow • A few blockbusters compensate for many failed investments
Focus of study: Private Equity	**Mezzanine Financing**	• Debt and equity hybrid, used by established companies in need of growth finance, but without collateral or desire to dilute ownership • Allows lenders to share some upside potential with the company
	Minority Stakes	• Companies seeking growth finance without giving up control (<50%) • Key issue for investors is protection of minority shareholders' rights
	Controlling Interest	• Often executed in combination with debt (leveraged buy-out) • Exits conducted via public offerings or strategic buyer sales
	Distressed Assets	• Buyout of either whole distressed companies or parts (assets, debt) • Companies needing liquidity, or cannot maximize asset values

1.5 **Equity investments can be made either directly or through specialized intermediary funds, and most DFIs use both mechanisms.** Seed investors

3 Also for being an unlikely IIC focus, the study will exclude direct investments in market-listed equities. The study will also likely exclude PE controlling interest strategies, for the same reason.

are often individuals, while VC and PE investing is usually conducted by specialized funds that manage third party's investments. Funds are a cost-effective mechanism to reach multiple investees, amortizing the costs of high quality managers and diversifying risks, but management fees can significantly reduce returns for investors. Funds tend to specialize by geography, sector, or investee type. Fund managers, known as general partners, are charged with deploying the pooled capital into the targeted type of enterprises. They make investment decisions on behalf of other investors, known as limited partners, within the goals and restrictions set out in specific funds' agreements.

1.6 **Equity investments tend to offer higher returns, but also higher risks than loans.** Lenders limit their risk exposures by predefining periodic repayments of interest and principal, and establishing contractual covenants to increase the likelihood of repayment. By contrast, equity investors share the risks and potential profits of investee companies, as well as capital gains. Equity cash flows streams are less certain, as they depend on the investee's ability to first cover debt repayments, their dividend policy and ultimately the profitable sale of the equity investment position. There are also hybrid structures, e.g., mezzanine debt, allowing for a debt-like predefinition of repayment streams, while adding some equity-like traits, e.g., profit sharing in the event of positive investee results.

1.7 **Equity investments also differ in their capital requirements, liquidity and currency exposure.** Compared to loans, equity investments require more capital. For example, risk weights for multilateral's equity investments can be up to 100%, whereas for other asset classes like corporate loans, weights can range from 6% to 31%[4]. As a result, $1 in of additional equity investments could mean US$3 to US$16 in foregone loan investments to maintain capital adequacy ratios. Equity investments are also more illiquid, because unlike loans there is uncertainty as to the timing and amount of repayments. Finally, equity also introduces currency risks, as repayment flows are derived from dividends and market valuations directly tied to the local currency where investee companies conduct their business.

1.8 **Despite these challenges, equity investing has the potential of unlocking economic value by supporting capital-constrained companies to grow and become more efficient.** Equity can be leveraged, i.e. allowing companies to raise additional debt funding. By providing long-term funding, managerial and best practices support, equity investing can also help companies to grow faster, increase productivity, innovation, and ultimately competitiveness. Company-level productivity can translate into competitiveness for the economy as a whole, potentially through demonstration effects and reduced cost of inputs. Likewise, equity investing can create new or better employment by promoting the creation of businesses that push the technological frontier through innovation – but such investments can also substitute capital for labor. Equity investing can increase the tax base, formal employment and exports. New, more sustainable employment contributes to human capital accumulation and economic growth through expenditure multiplier effects. Dalberg estimated that each PE dollar invested returned additional US$4-6 in taxes, wages, and supply chains.[5]

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4 Standard & Poor's Supranationals, Special Edition, 2015 (p.34, Credit Risk Capital Haircuts).

5 Assessing the impact of MIF's venture capital program in Latin America, Dalberg, 2012

Figure 1.2: Expected development effects of equity investing

Equity investing offers …	which can have direct effects on investee companies …	and indirect effects on the overall economy
• Risk-capital, providing long-term funding and the ability to mobilize additional debt funding. • Support for management processes • Ability to influence corporate governance and E&S practices	• Revenues and margins • More or better jobs • Innovation • Productivity	• Exports • Taxes • Enhanced competitiveness • Potential demonstration effects

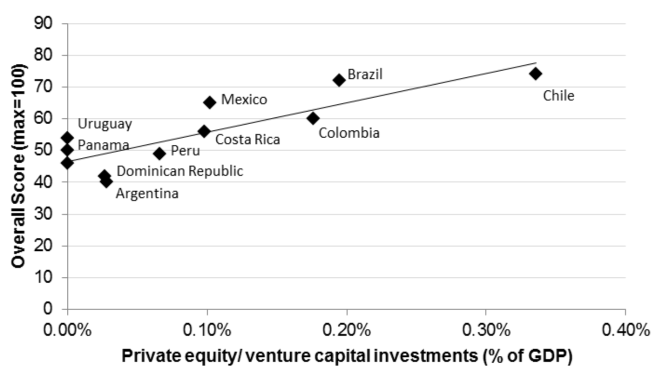
Source: OVE based on literature review

1.9 **LAC lags behind in its access to equity investments**. All emerging markets combined accounted for less than 20% of global equity investments over the last decade. In 2014, emerging Asia accounted for a majority (66%) of emerging market equity investments, while LAC had an 18% share. Annual PE funds raised in LAC averaged roughly $5 billion over the last decade, with variations **linked to economic fluctuations.6**

Box 1.2: Barriers for equity investing vary greatly by country

Chile, Brazil, Mexico, Colombia and Costa Rica have relatively good conditions for equity markets. The Latin American Venture Capital Association (LAVCA, whose creation in 2002 MIF supported) produces periodic scorecards assessing the equity investment environment in LAC countries. Rating criteria include the adequacy of laws on VC/PE fund formation and operation, tax treatment of PE/VC funds and investments, protection of minority shareholder rights, restrictions on local institutional investors investing in PE/VC, bankruptcy regulation, capital market development and feasibility of local exits, etc. Countries that have attracted high equity investment volumes tend to have equity investing environment scores above 60.

Countries with better equity investing environment scores tend to attract more equity investments

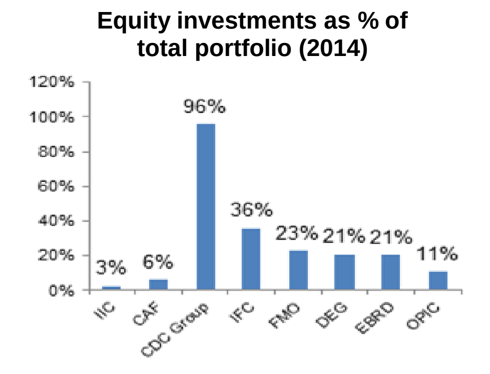


Source: Equity Investing Environment Score vs. PE/VC Investments, LAVCA Scorecard, 2015

6 Private Equity and Venture Capital in LAC, CAF 2015.

1.10 **In part reflecting their various capital positions and strategies, other DFIs have so far invested more intensively in equity than IIC.** Equity has played a relatively small role in IIC, both in terms of approvals and earnings, in part explained by capital constraints and the relatively small size of the institution. By contrast, other DFIs, such as the International Finance Corporation (IFC), emphasize the strategic importance of equity investing. While the total approved volume for IIC has been less than $500 million over 25 years, IFC invests about US$500 million every year. IFC's equity investments averaged about 20% to 30% of total IFC commitments, but accounted for a much larger share of IFC's total earnings. Other DFIs place a similar emphasis on equity investing, in part because they see it as a development tool to help create new jobs, foster innovation, as well as a source of income for themselves.

Figure 1.3: IIC equity investments are a small fraction relative to other DFIs



Source: DFIs financial statements

II. APPROACH AND METHODOLOGY

2.1 **The core content of this study will be a comparative benchmarking of equity strategies, results and processes of selected DFIs and other comparators.** The study will try to draw parallels and contrasts between the comparators and IIC's own equity investing experience over the last ten years. Key questions underlying OVE's comparative analysis include the following:

- Strategy formulation: Why do DFIs and other comparators invest in equity? What are the key considerations when deciding to invest directly or through funds? How do DFIs decide how much to invest in equity? How do DFIs handle conflicts of interest when they are involved in both debt and equity investments with the same investees?
- Organization: How are equity teams internally structured and staffed? What are the performance indicators and compensation policies? What is the governance of equity investments decision-making?
- Due diligence and client selection: How do DFIs and other comparators assess and select direct investees and funds?
- Structuring: How do DFIs and other comparators structure equity investments to balance their interest in financial and development goals?
- Monitoring and supervision: How do DFIs and other comparators add value during the supervision stage? How do DFIs appoint directors and exercise voting rights? How does monitoring of equity investments differ from loan investments?
- Divestment: What are the best practices regarding equity divestment, in terms of criteria, responsibilities and processes?

- Lessons learned: What operational lessons have DFIs and other comparators learned from their experience with equity investments?
- Results: What development and financial results have DFIs and other comparators achieved though equity? How were these results measured? Did results differ by key characteristics (e.g., funds vs. direct investments; type of fund; sector; investment vintage), and if so, why?

2.2 **Comparators will be selected by OVE guided by criteria pointing to their experience being relevant for IIC (Box 2.1).** OVE will draw comparators from among peer DFIs to learn from their results and practices (Table 2.1 shows an illustrative list of potential comparators, subject to adjustment during the study). OVE will also review the experience of selected PE funds and other impact and development oriented equity investors from which IIC could learn good practices and gain information about market conditions in LAC. In all cases, OVE will take into account the suitability of these practices for IIC given its capital constraints, organizational capabilities, and specific mandates.

Box 2.1: Comparator selection criteria

- **Equity depth:** track record of sufficient volume, number of equity operations
- **Instrument mix:** (preferably) significant debt business operated along with equity investing
- **Geographic mix :** regional experience (preferably LAC) involving work in large and small countries
- **Investment focus:** aim to support mid-market companies, both directly or through funds
- **E&S focus:** Expertise and commitment to sustainability and E&S issues

Table 2.1: List of potential comparators (to be adjusted during the study)

Category	Potential Comparators
DFIs with significant presence in LAC	IFC, CAF, MIF
Other DFIs with relevant practices	EBRD, CDC, FMO, DEG, PROPARCO, ADB
Selected PE funds	The Abraaj Group, Advent, Ashmore Colombia, Fondo de Fondos (Mexico)
Other impact and development oriented equity investors	Selected LAC development banks and pension funds

2.3 **The study will focus on practical strategic, organizational and operational issues of use to IIC, thus it will not cover other IDBG lending or technical support targeting barriers to the development of equity investing markets, nor focus on quantifying the effects of equity investments on final beneficiaries.** Equity operations cannot remove all market constraints (Table 2.2), yet they can play an important role – for the companies receiving them as well as for IIC's profitability. For example, equity investments can provide risk capital in markets with limited fundraising options. Equity investing also helps deepen capital markets and improve exit options, thus attracting additional funds. Moreover, equity operations can help build capacity of local fund managers and their track records and experience in the region. OVE will focus on IIC's equity investing operations, and will review other equity related work by the IDBG only to the extent that it may have affected the results of equity investments.

Table 2.2: Using the appropriate tool to address barriers to equity investing

Barriers to equity investing	Potential tools to address them
Uncertain political, macroeconomic or currency environments	Non-equity-operation (SG policy loan): Supports macroeconomic reforms and stability.
Underdeveloped regulatory institutions and uncertain tax environments	Non-equity-operation (SG policy loans/TA to governments): Support creation of a stronger enabling environment
Weak contract enforcement and uncertain legal systems	Non-equity-operation (SG policy loans/TA to governments): Support creation of a stronger enabling environment
Underdeveloped capital markets limiting fundraising and exit options	Equity investments: Provide funding and deepen capital markets Non-equity-operation (SG policy loan/TA to governments): Support development of capital markets
Limited equity business track record and capabilities	Equity investments and TA: Build track record and increase equity investing capabilities
Poor corporate governance practices	Fund managers or development finance institutions can support and require corporate governance improvements.

2.4 **OVE will use a mix of methods to collect and analyze the information**. First, OVE will do a desk review of IIC's equity projects and interview relevant officers to extract lessons learned from IIC's equity experience. Second, OVE will analyze comparators' public documents, evaluations and operation manuals to understand their strategies, map their investment practices, and identify their organizational arrangements. Third, OVE will conduct interviews with comparators' staff to gather lessons from their experience in equity. Fourth, OVE will reach out to institutional investors, fund managers, regulators and PE associations to characterize the equity investing environment and identify areas where IIC can add value to investees going forward. Finally, OVE will seek to validate promising practices with peers and industry experts, including those in relevant VC/PE associations (e.g., LAVCA, EMPEA).

2.5 **The core team includes Roland Michelitsch and Alejandro Soriano (as co-team leaders), Ernesto Cuestas, Rocio Funes and Danya Churanek.** In addition, Jack Glen, an external consultant with robust expertise in DFIs' equity investing will also support the team. Finally, industry experts will be involved as needed to validate the findings. The expected timeline is shown in Table 2.3.

Table 2.3: Expected Timeline for the study

	April	May	June	July	Aug	Sep	Oct	Nov
Approach paper								
Review of IIC's EI experiences: desk review and interviews with EI officers								
Design benchmarking questionnaire								
Selection of comparators and outreach								
Conduct benchmark: literature review, interviews with DFIs								
Preparation of technical note and peer review								
Relevance assessment of good practices, given IIC's current state								
Finalization of study for presentation to Board								