

## Guest Article: DEG Reports Strong Developmental Effects of Its Private Equity Fund Portfolio

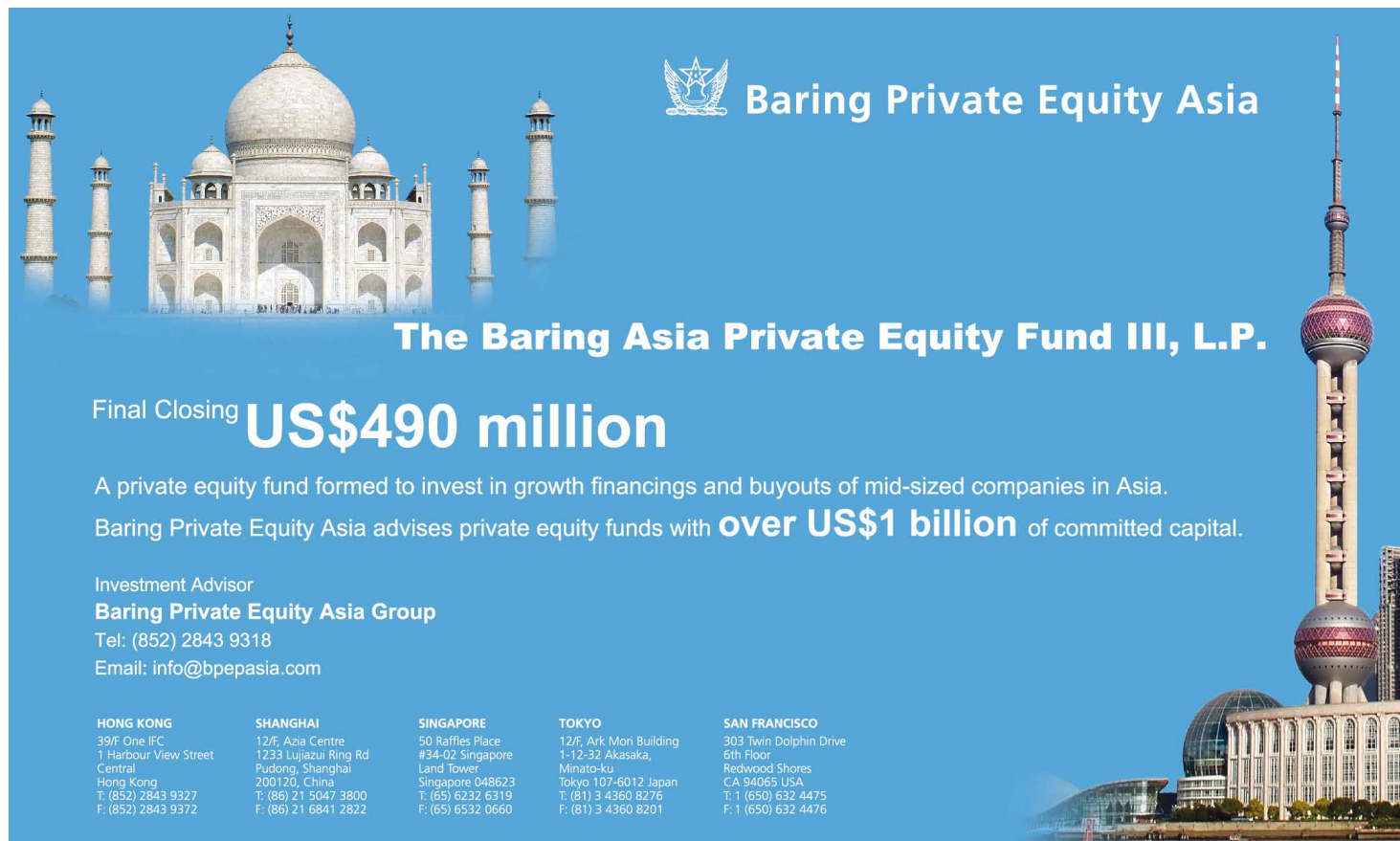
by Dr. Thomas Koch, Head of Economics and Development Policy Department / DEG


Can private equity investments make life better for people in emerging markets? DEG (Deutsche Investitions- und Entwicklungsgesellschaft mbH), a German Development Finance Institution that has invested in 34 private equity funds in emerging markets and developing countries, has set out to answer this question through an analysis of the development effects of its portfolio. The question is of obvious interest for LPs such as DEG that invest out of a development mandate, but it is also increasingly important for emerging markets GPs. Recent media criticism and government opposition in China, Germany, and South Korea illustrate the risks that private equity fund managers face if their investments are not perceived to benefit the local population. To date, there is little data or analysis that managers can draw on to illustrate the positive effects of emerging markets private equity.

The DEG study, which is based on December 2005 data, provides some encouraging results:

- 73% of the 34 funds in which DEG has invested have shown significant development effects in terms of job creation, poverty reduction and capital market strengthening.
- Investments by funds in DEG's portfolio have contributed to the creation or maintenance of more than 180,000 jobs.
- 85% of the funds' investee companies (approximately 300 in total) improved their corporate governance, and 65% improved accounting and reporting systems.
- The development effects score for the funds in the portfolio is positively correlated with their financial performance.

This study indicates that private equity can be a win-win proposition for emerging market countries.



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## DEG's Fund Rating System

The study draws on DEG's internal rating system, called GPR ("Geschäftspolitisches Projekt-Rating"), which monitors private equity funds according to their effectiveness in four categories, one of which is development effects. The development effects rating takes into account such factors as the number of workers employed by investee companies, the mobilization of additional local capital by the funds, and the strengthening of investee companies' systems and procedures. However, the development effects rating cannot fully determine causality (e.g., jobs specifically attributable to the private equity investment). This would require proof of what a company would have done if it had not received the investment which is methodologically quite a challenge and beyond the scope of DEG's rating.

The DEG portfolio of 34 funds used in this rating analysis is relatively diversified and therefore representative of the broad range of emerging markets private equity activities. In terms of vintage year, 9% of the funds date from 1987-1995, 47% from 1995-2000, and 44% from 2000-2005. The funds range in size from €5m to €220m, with the average fund having €50m in commitments. The regional distribution is: Eastern Europe 31%, Asia 28%, Africa 27% and Latin America 14%.

## Results

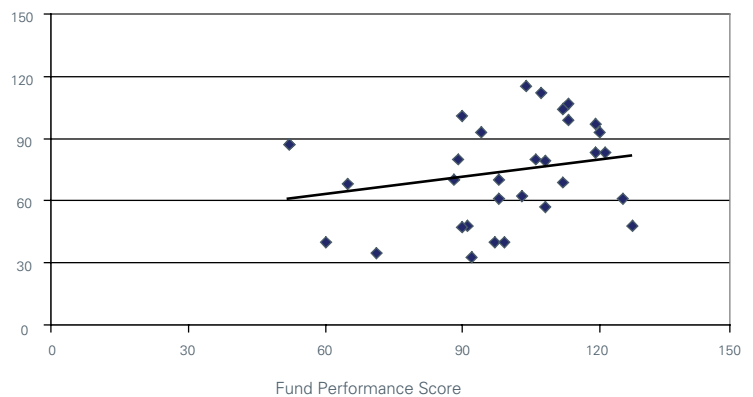
The graph below illustrates the results of DEG's portfolio analysis as of December 31, 2005. The right hand column shows how the funds portfolio performed according to their development effects score, with 73% of the funds meeting DEG's criteria for a grade of very good, good or fully satisfactory. The left hand column gives DEG's

overall evaluation of its investments, which takes into consideration the development effects score, plus:

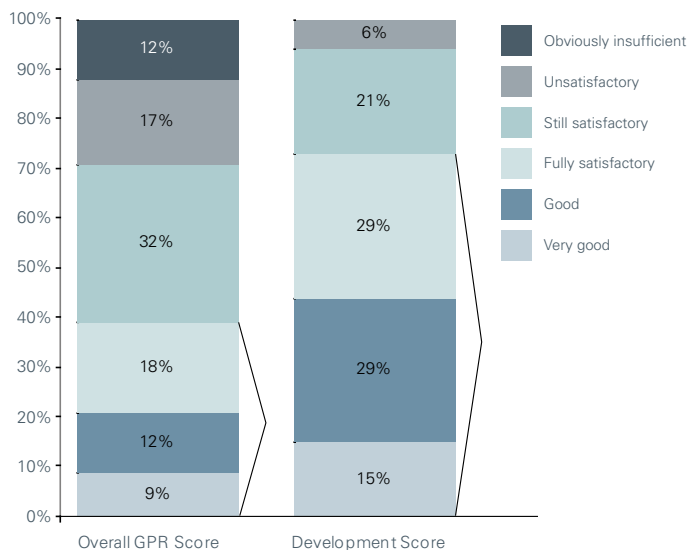
- An evaluation of DEG's role with the fund;
- DEG's return net of all fees and monitoring costs;
- A risk-adjusted rating of the fund's performance, which combines a current and projected IRR with a downward adjustment for high risk countries and other market or management risk factors.

Only 39% of DEG's funds scored in the top three grades on the overall evaluation, compared to 73% for development effects. The main reason for this difference is relatively weak return on equity and investment performance by a significant percentage of the funds.

Correlation between Performance & Development Effects (n=34)



Evaluation of DEG's Private Equity Fund Portfolio: Grouping of Funds by Overall and Developmental Scores



Although the funds in DEG's portfolio did better in terms of their development effect than their performance, the two variables are positively correlated, meaning that the better performing funds tended to have greater development effects. (This correlation is illustrated in the graph above by the positively slanted line.)

Specific development effects identified by the study include:

- **Employment:** More than 180,000 jobs were created or secured by the investee companies of the funds. On the fund level, about 300 professional jobs were created in fund management partnerships. In developing countries, with unemployment rates usually running at elevated double digits, the employment effect doubtlessly contributes to reducing poverty.
- **Capital market development:** 35% of the funds mobilized additional local capital investments into their investee companies. 59% of the funds invested in sectors

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(e.g., IT and health care) where long-term equity capital was not previously available. 62% of the funds invested in small-and medium-sized enterprises (SME), for which long-term equity capital is typically unavailable. 32% of the funds adopted World Bank risk management guidelines related to environmental and social management, which represents a form of adherence to international norms as well as a deepening of risk mitigation strategies.

- Private sector development:

85% of investee companies improved their corporate governance. 65% improved accounting and reporting. 79% of the investments by the fund involved expansion and/or modernization, including technology transfer.

## Next Steps

DEG's rating system has been adopted by several other European Development Finance Institutions, which will allow for more comprehensive studies with broader data in the future, as well as comparisons across portfolios. Other institutions, such as the

International Finance Corporation, are developing parallel evaluation tools. In future years, these efforts should result in a deepening understanding of the development impact of private equity investing in emerging markets and developing countries, and, hopefully, more evidence for government and private sector support for this growing asset class.

DEG, member of KfW Bankengruppe (KfW banking group), finances investments of private companies in over 80 developing and emerging countries. As one of Europe's largest Development Finance Institutions, it promotes private business structures to contribute to sustainable economic growth and improved living conditions. In 2005, DEG had new commitments of 672 million euros with about 100 companies. Private equity is an important part of DEG's portfolio in order to promote equity finance.

For more information see <http://www.deginvest.de>

For the detailed report of DEG's PEF portfolio analysis, please refer to the EMPEA website (<http://www.empea.net>). ●



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Although the specific selection criteria will be set forth in the call for proposals, the criteria that OPIC will consider in selecting one or more Funds for possible OPIC financing are expected to include: (i) the credibility and thoughtfulness of the proposal and the consistency and clarity of the fund manager's investment strategy; (ii) the track record of the prospective fund manager in making private investments in the fund's targeted countries; (iii) the experience, depth, credibility and team cohesiveness of the fund manager; (iv) the fund manager's experience serving as a fiduciary and managing institutional capital, and its ability to meet reporting requirements and administering a fund; (v) the competitive position of the fund manager, including deal sourcing capabilities, reputation and capital market access; (vi) the ability of the fund sponsors to raise the capital to close the proposed fund within a reasonable time; (vii) the proposed fund's developmental impact in its targeted region; and (viii) the terms and conditions of the proposed OPIC financing, including the leverage ratio sought.

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