DEVELOPMENT FINANCIAL INSTITUTIONS AND THEIR ROLE IN SUPPORTING EMERGING MARKETS PRIVATE EQUITY FUNDS

Anton Sorin GABRIEL
"Al. I. Cuza" University of Iași, Faculty of Economics and Business Administration
Iasi, Romania
sorin.anton@uaic.ro

Abstract: *Development financial institutions have emerged in the last years as major investors in the private equity industry. Their main goals are to create new jobs, to foster innovation and to develop the private sector. The aim of the paper is to analyze the role played by the development financial institutions in the creation and development of emerging markets private equity funds in the light of financial crisis started in 2008. We found that many development banks have increased their financial support to the emerging markets private equity funds and have improved the standards and norms of the local industry. They played a countercyclical role during a difficult period when private investors proved reluctant in backing new private equity funds.*
Keywords: *Multilateral development banks; private equity funds; emerging markets; firms' financing; financial crisis.*

INTRODUCTION

As commercial banks are reluctant in financing news ventures, SMEs' access to capital is still costly and insecure especially in emerging markets. Recognizing the financial constraints faced by innovative SMEs and their need for alternative financial resources, development financial institutions (or multilateral development bank - MDB) have expanded their focus to the SMEs focus or have created a specialized arm on this (for example, European Investment Fund). Almost all of the MDB have as strategic objective the development of private sector by supporting SMEs.

MDBs support the SMEs sector the their countries of operations through various instruments such as direct loans, credit lines, guarantees, direct equity investments, participation in private equity funds, microfinance, trade finance, leasing facilities, and to a lesser extent through risk sharing facilities. A substantial proportion of the MDBs' activity in support of SMEs (private sector financing) is channelled through financial intermediaries (FIs) including local commercial banks, specialized microfinance institutions, private equity funds, regional and national development banks, and insurance and leasing companies. The rationale for engaging with FIs is the possibility of reduced transaction costs. Development financial institutions work mainly with local commercial banks, but private equity funds are becoming a "favoured vehicle" (Kwakkenbos and Romero, 2013).

The aim of the paper is to analyse the activity of multilateral development banks in the support of private equity funds after the onset of current financial crisis. We exclude some MDBs (Asian Development Bank and Inter-American Development Bank) from our analysis due to the missing of recent data on private equity investments.

LITERATURE REVIEW

Several papers highlighted the effect of private equity investments at micro- and macroeconomic level. Bernstein *et al*. (2010) found that industries financed by private equity funds in the previous five years have grown more quickly in terms of productivity and employment. Colombo *et al*. (2009) showed that venture capital investments have a positive effect on total factor productivity of New Technology-Based Firms (NTBFs). Popov and Roosenboom (2009) studied the effect of private equity investments on the level of patent filings in Europe during 1991-2004. They found that a 1% increase in private equity investment will cause an increase in patent filings by between 0,04%–0,05%. According to Boucly *et al.* (2011), private equity-backed companies are able increase their capital expenditure and become more profitable than their competitors. Moreover, leveraged buyout companies experienced greater job and wage growth than other similar companies. Strömberg (2009) and Frontier Economics (2013) provide a comprehensive literature review on economic and social impact of private equity in Europe.

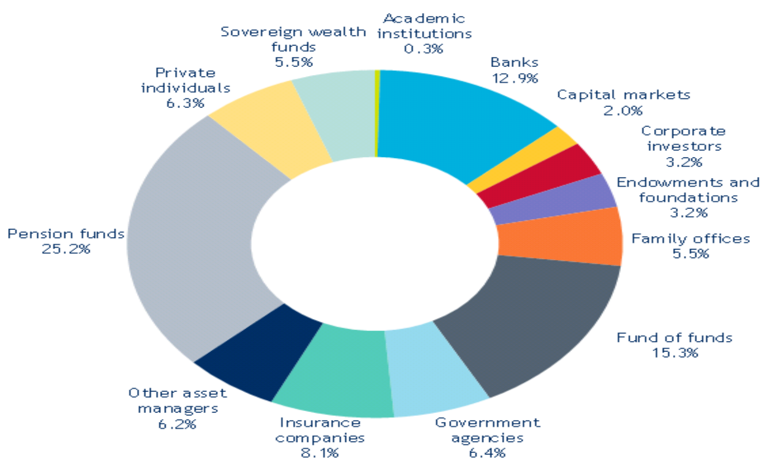
There are only a few paper focused on the activity of MDBs in private equity industry. Pissarides (1999) emphasized that European Bank for Reconstruction and Development (EBRD) invested in private equity funds aiming to improve the SMEs' access to finance in Central and Eastern European countries. Settel *et al.* (2009) analyzed the rationales for multilateral development financial institution (MDFI) private equity fund investments and found that developing financial markets, supporting infrastructure development and promoting growth in SMEs, innovation and entrepreneurship are the main reasons for their involvement.

EVOLUTION OF MDBs' ACTIVITY IN PRIVATE EQUITY INDUSTRY

Since the onset of current economic and financial crisis, MDBs took several measures in order to support the development of emerging private equity markets. Nowadays, many international financial institutions are considered the largest private equity fund investors in their region of operations. For example, EIF is a leading financial institution in the European Private Equity market, while EBRD is the largest private equity investor in the CEE and Central Asia. ADB focuses on private equity funds in Asia, while IFC has a global focus.

Figure 1 presents the main sources of funds private equity in Europe for the period 2007-2012. We notice that the government agencies is the fifth provider of financial resources with 6,4% of total capital raised, after pension funds (25,2%), fund of funds (15,3%), banks (12,9%) and insurance companies (8,1%). Government agency means a country, regional, governmental or European agency or institution for innovation and development, including structures such as the European Bank for Reconstruction and Development (EBRD) and the European Investment Fund (EIF). However, there are big differences from one year to another and from one region to another. For example, in 2012 in Central and Eastern Europe, government agencies (which include multilateral development banks) were again the largest source of capital providing 29% of the total capital raised for this region (EVCA Central and Eastern Europe Task Force, 2013). During the period 2009-2012, government agencies have been the most important providers of risk capital, investing over 30% of cumulative capital raised for this region. In 2007-2008, government agencies contributed with only 3% of cumulative capital raised.

Figure 1. Main sources of funds of private equity in Europe (2007-2012)



Source: European Private Equity and Venture Capital Association, www.evca.eu

According to Settel *et al.* (2009), the Asian Development Bank (ADB) and the International Financial Corporation (IFC) were the first multilateral development bank to invest in emerging market private equity funds since the 1980s. After a decade, other multilateral development banks started to invest in private equity funds. The European Bank for Reconstruction and Development (EBRD) made its first fund investment in 1992. The European Investment Fund (EIF) began investing in venture capital funds in 1997.

A few years later, multilateral development banks started to formalize their private equity fund operations. EBRD created a group dedicated to investments in private equity funds in 1997. In 2000 IFC created Private Equity and Investment Funds Group in order to select and manage its investments in private equity funds.

We conduct an analysis of the MDBs activity based on the public available information. Table 1 presents the main MDBs active in the private equity markets, their level of current commitment in PE funds and current strategy. According to the data available for the end of 2012, EIF is the largest provider of capital for private equity funds, followed by European Bank for Reconstruction and Development and International Finance Corporation.

The European Investment Fund (EIF) represents the European Investment Bank (EIB) Group's specialist provider of risk financing to the benefit of SMEs across Europe. EIF delivers three types of instruments for SMEs, namely equity instruments, guarantee and credit enhancement instruments, as well as microfinance using a variety of financial intermediaries. An important part of EIF's activity is channeled through private equity funds.

Table 1. Overview of MDBs with private equity operations (2012)

MDB	Acronym	Region	Current PE fund investments (#)	Current PE fund commitments	Current strategy
African Development Bank	AfDB	Africa	37	$836 million	Infrastructure, financial services, small businesses
Asian Development Bank	ADB	Asia	n.a.	n.a.	Financial market development
The Multilateral Investment Fund and the Inter-American Investment Corporation (members of Inter-American Development Group)	MIF, IIC	South America	n.a.	n.a.	Support to SMEs, entrepreneurship
European Investment Fund	EIF	Europe	435	Eur 6,9 billion	High-tech and early-stage segments
European Bank for Reconstruction and Development	EBRD	Central and Eastern Europe, Asia & Southern and Eastern Mediterranean	96	EUR 2,7 billion	Small and medium-sized enterprises

		(SEMED)			
International Finance Corporation	IFC	Global	180	$ 3 billion	Growth equity funds, climate change, and SME funds

Source: Updated after Settel et al., 2009

The EIF's portfolio of private equity investments has grown considerably between 2009 and 2012 (see table no. 2). In fiscal year 2012, EIF has EUR 6,95 billion in assets under management across 435 funds. During the same period, EIF made new equity commitments of EUR 4,1 billion which catalyzed over EUR 20,8 billion from other institutional investors. As a response to the current financial crisis and its implications on SME's financing, the EIB has increased the overall volume of its investments in private equity funds from one year to another. EIF played a critical role in stimulating the development of private equity market in Europe as a provider of funds and, to the same extent, as a manager of some venture capital funds (Anton, 2013).

Table 2. EIF investments in PE funds in Europe during 2009-2012 (EUR billions)

Year	2009	2010	2011	2012
Private equity assets under management (in EUR billion)	4,103	5,367	5,919	6,952
Private equity new commitments	0,7	0,9	1,1	1,4
Private equity - leverage	3,1	4,6	6,1	7

Source: European Investment Fund, www.eif.org

EBRD is another European multilateral development bank active in the private equity markets with two aims: providing efficiently equity capital to companies (especially small and medium sized enterprises) and building a sustainable private equity industry in the region.

The bank usually committed about 90% of equity capital to a wide spectrum of PE fund sizes and investment strategies, regional and country-specific funds, and generalist and sector-specific funds.

In 2012, the EBRD invested €336 million in 11 private equity funds. Over the last twenty years of activity in this market, the EBRD's total net commitments to private equity funds amounted to EUR 3,4 billion with total capital of EUR 18,2 billion. With investments in over 147 private equity funds, EIF has become the largest private equity funds investor in its region of operations (Central and Eastern Europe, Asia & Southern and Eastern Mediterranean - SEMED). In these regions private equity markets are underdeveloped and EBRD's support consists not only in capital, but also in standards and policy requirements to the funds in which it invests. The EBRD's current portfolio comprises 96 active funds, backing over 62 fund managers for over EUR 2,7 billion in commitments, with total capital of EUR 16,1 billion (EBRD, 2013). The main recipient for investments is Russia, accounting nearly 35% of the EBRD's overall private equity portfolio.

With investments in over 180 funds, IFC has become a leading player in emerging market private equity funds around the world. According to official data, IFC backed around 10% of the funds created since 2000 focused on emerging markets. In 2012, the IFC's total net commitments to private equity funds were around $3,0 billion. In the medium term, IFC is ready to back twenty to twenty-five funds globally with investments up to $500 million per year. IFC's strategy is focused on growth equity funds, climate change, and SME funds.

Other multilateral development banks with private equity operations are African Development Bank Group (AfDB), Asian Development Bank and two members of the Inter-American Development Bank (IDB) Group, the Multilateral Investment Fund (MIF) and the Inter-American Investment Corporation (IIC). The size of their portfolio of private equity investments is below the level of investments made by EIF, EBRD and IFC. In 2012, the AfDB's portfolio of private equity investments was $836 million, with commitments to 37 funds.

Overall, the MDBs support the development of emerging markets private equity funds in many ways. First, MDBs back private equity funds which further provides to the enterprises situated in emerging markets capital and the expertise needed to expand their activities, to create jobs and to drive economic growth.

Secondly, multilateral development banks also support private equity funds focused on emerging markets acting as a catalyst to mobilize private institutional quality investors. Empirical evidences suggest that there is a large multiplier effect when a MDB invests in a private equity fund. For example, African Development Bank reported that for every $1the bank invests in private equity, a further $5 is invested by other institutions and individuals. Moreover, Asian Development Bank has a multiplier effect of 8,08 for every dollar that the bank has allocated to private equity funds.

Thirdly, MDBs have improved international private equity and venture capital valuation guidelines. Furthermore, the presence of international financial institutions in these markets also brings economic, social and governance reporting and a high degree of conformity to international norms and standards.

CONCLUSIONS

Supporting private sector in developing countries represents a key task of multilateral development banks. Private sector is a provider of income, jobs, goods, and services to enhance people's lives and contribute to sustainable poverty reduction. One way to develop private sector is through financial intermediaries, namely private equity funds. The main advantage of this approach is that private equity funds have the potential to reach private enterprises, especially small and medium-size enterprises. SMEs represent an important source of job creation, economic growth, entrepreneurship and innovation.

All of the multilateral development banks have expanded their presence in private equity funds in the last years. During the current financial crisis, when there was a sharp retrenchment in the debt and equity capital available for SMEs in developing economies, MDBs played a countercyclical role by increasing their investments in PE funds focused on emerging markets. The majority of private equity funds backed by MDBs invests in small and medium-sized enterprises and thus contributes to reduce their financing gap.

In many regions of the world, multilateral development banks represent a major source of capital for private equity funds. Through their activities, MDBs have been key actors in the creation and development of private equity industry in emerging markets.

REFERENCES

[1] African Development Bank Group (2013). *Supporting the Transformation of the Private Sector in Africa. Private Sector Development Strategy, 2013-2017*. Retrieved from http://www.afdb.org/.

[2] African Development Bank Group (2013). *Private Equity Investment in Africa in Support of Inclusive and Green Growth*. Retrieved from http://www.afdb.org/.

[3] Anton, S.G. (2013). Multilateral Development Banks and their Role in Supporting European SMEs during the Current Financial Crisis. *Acta Universitatis Danubius. Oeconomica*, Vol 9, Issue no. 6, pp. 82-88.

[4] Bernstein, S., Lerner, J., Sørensen, M., Strömberg, P. (2010). *Private Equity and Industry Performance*. NBER Working paper 15632, Cambridge.

[5] Boucly, Q., Sraer, D., Thesmar, D. (2011). Growth LBOs. *Journal of Financial Economics*, Vol. 102, pp. 432–453.

[6] Colombo, M. G., Croce, A., Murtinu, S. (2009). *Ownership structure and performance in high-tech start-ups: an empirical study*, Working Paper, Politecnico di Milano.

[7] EBRD (2013). *EBRD Private Equity Funds Portfolio to 31 December 2012.* Retrieved from www.ebrd.com.

[8] EVCA Central and Eastern Europe Task Force (2013). *Central and Eastern Europe Statistics 2012*, Retrieved from www.evca.eu.

[9] Frontier Economics (2013). *Exploring the impact of private equity on economic growth in Europe*. London.

[10] Kwakkenbos, J., Romero, M. J. (2013). Engaging the private sector for development: The role of Development Finance Institutions?. In: ÖFSE (Hg.) Österreichische Entwicklungspolitik, Analysen ▪ Berichte ▪ Informationen mit dem Schwerpunktthema “Private Sector Development – Ein neuer Businessplan für Entwicklung?”, Wien, pp. 25-30.

[11] Pissarides, F. (1999). Is Lack of Funds the Main Obstacle to Growth?. *Journal of Business Venturing*, Volume 14, Number 5, pp. 519-539.

[12] Popov, A., Roosenboom, P. (2009). *Does private equity investment spur innovation? Evidence from Europe*, Working paper, European Central Bank.

[13] Settel, D., Chowdhury, A., Orr, R. (2009). The Rise of MDFI Investments in Private Equity Funds. *The Journal of Private Equity*, Vol. 12, No. 2, pp. 60–76.

[14] Strömberg, P. (2009). *The Economic and Social Impact of Private Equity in Europe: Summary of Research Findings*, Stockholm.

[15] Wilton, D. (2013). *The benefits of private equity investment*, in Commonwealth Trade & Investment Report 2013.

[16] www.evca.eu

[17] www.ebrd.com
[18] www.eib.org
[19] www.eif.org
[20] www.privateequityinternational.com