Multilaterals and Infrastructure Funds: *A New Era*

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This article examines the growing role of multilateral development finance institutions (MDFIs) as investors in private infrastructure funds in emerging markets. Such arrangements are becoming commonplace in Asia, Africa, Latin America, and the Middle East. It appears that MDFIs have embraced private-equity-style fund investments as a new vehicle for infrastructure investing, which is an important trend because it represents a new investment format for the MDFIs, a need for new fund management practices, and new risks and opportunities.

The article addresses several key research questions: To what extent do MDFI private-sector portfolios now include allocations to private equity fund investments? Why are MDFIs establishing new platforms for investing in private infrastructure funds? And what are the common practices today among MDFIs in terms of fund selection, fund management, and performance reporting? The data reported was collected from public documents and telephone interviews with MDFI representatives.

APPROACH OF THE STUDY

The study reviewed the universe of MDFIs and pinpointed 14 institutions that currently hold or have formerly held investments in private equity funds.[1] Of these 14 MDFIs, we selected eight—namely, those with the largest private equity programs currently under management. The institutions studied were:

- African Development Bank (AfDB)
- Asian Development Bank (ADB)
- European Bank for Reconstruction and Development (EBRD)
- European Investment Fund (EIF)
- Inter-American Investment Corporation (IIC)[2]
- International Finance Corporation (IFC)
- Islamic Development Bank (IDB)
- Multilateral Investment Fund (MIF)[3]

Interviews with representatives of the eight MDFIs were conducted between October 1 and November 15, 2008. Informants included senior economists, directors of private equity fund programs, and infrastructure investment professionals.

EXPANSION INTO PRIVATE INFRASTRUCTURE FUNDS

For the most part, the original mission of the MDFIs was to contribute to development by financing public-sector entities. The Asian Development Bank was established in the 1960s as an Asian financial institution whose mission was to foster economic growth and cooperation in that region. In the first decade of operations, the ADB focused much of its assistance on food production, rural development, and technical assistance (www.adb.org). The Islamic Development Bank was established in 1975. Its objectives were to promote the Islamic financial industry and its institutions, alleviate poverty, and promote cooperation among member countries (www.isdb.org). The EBRD was established more recently (in 1991) to function as a catalyst of change by promoting co-financing and foreign direct investment, mobilizing domestic capital, and providing technical assistance (www.ebrd.com) to the crumbling institutions of central and eastern Europe.

The International Finance Corporation has had a private sector mandate since it was established in 1956. Its objectives are to lend money, take equity positions, and provide technical expertise in appraising investment proposals in developing countries alongside private-sector counterparts (www.ifc.org).

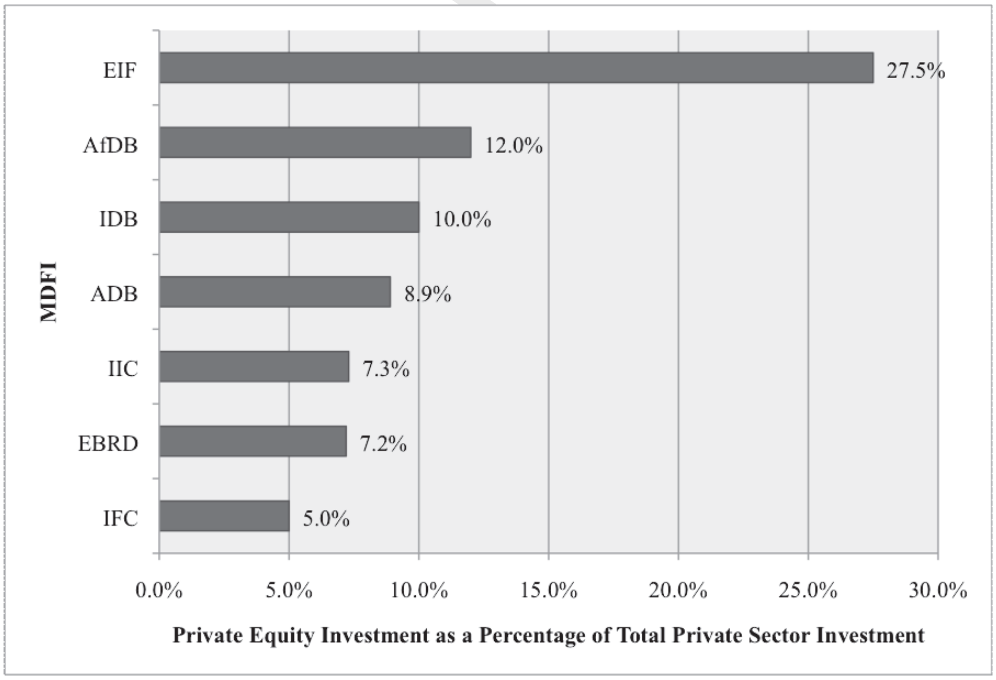
Over time, all of these institutions have become increasingly involved in private-sector operations, with most of this support coming in the form of debt financing. Today, multilateral development finance institutions are major providers of debt capital and guarantees, and to a lesser extent equity capital. They support both corporate entities and project companies in areas including infrastructure, small and medium-sized enterprises, and financial institutions.

Several multilateral development finance institutions are now aggressively expanding into private infrastructure funds and other forms of private equity investing. Exhibit shows that eight of the largest MDFIs now allocate between 5% and 30% of their private sector investments to private equity funds.

The ADB and the IFC were among the first MDFIs to invest in private equity funds, and have been doing so since the 1980s. The Asian Development Bank made its first private-equity fund investment in 1983 (ADB [2008]). IFC made its first private-equity fund investment in the mid 1980s. Most of the other MDFIs began investing in private-equity funds in the 1990s.

The ADB program has been one of the fastest-growing. Its private-sector operations expanded by a factor of 40 times in six years, from $58 million in

E X H I B I T
MDFI Allocations to Private-Equity Funds



Source: Interviews with MDFIs, ADB Special Evaluation Study of Private-Equity Fund Operations, EBRD Annual Report 2007, EIF Website, IFC Annual Report 2007, IIC Annual Report 2007.

2001 to $2.3 billion in 2008. Similarly, almost a third of the African Development Bank's new investment activity is through the private sector. In 2007, the Inter-American Development Bank and the AfDB began periods of rapid growth in private-sector financing. For its part, the European Bank for Reconstruction and Development posted the largest volume of private-sector financing because, unlike the other MDFIs, its charter deliberately requires it to provide 60% of its financing to the private sector. In recent years, EBRD's split between private-sector and public-sector financing has been closer to 80% private and 20% public.

Five of the eight MDFIs have mandates to invest in infrastructure funds—namely, ADB, AfDB, IIC, IDB, and MIF (through clean energy). The other three MDFIs (EBRD, EIF, and IFC) have private-equity fund programs that are predominantly focused on supporting the development of financial markets and small and medium-sized enterprises, and not on infrastructure per se.

Typically, the investment dollars put to work by MDFIs in infrastructure funds flow into public-private partnerships, project financing, and infrastructure-enabling companies.

Under favorable conditions, infrastructure investments have been shown to contribute to economic growth and poverty reduction at both the macro and micro level (e.g., Aschauer [1989], Kessides [1993], Sanchez-Robles [1998], and Komives et al. [2001]).

Infrastructure investment is politically easier for MDFIs because infrastructure has historically been viewed as the natural responsibility of the public sector. Moreover, since MDFIs have traditionally worked in this sector, they are quite comfortable investing even though they may be relatively less familiar with the private-equity structure. Thus, infrastructure fund investments may serve as a bridge for MDFIs to learn about private-equity investing strategies and opportunities.

In Africa, the AfDB has added five to six new funds to its private funds portfolio in the last six months. According to the director of private sector operations, private equity is now the African Development Bank's "dominant vehicle for equity investment," and the bulk of that is in the infrastructure sector. Recent studies have concluded that deficient infrastructure in Africa is costing as much as one percentage point a year in per capita growth (Esfhani and Ramirez [2003], Calderon and Serven [2004]). That is why AfDB puts specific emphasis on supporting infrastructure, as evidenced by the fact that 74.8% of total loan and grant approvals in 2007 was dedicated to infrastructure (AfDB [2007]). According to a bank representative, the AfDB also devotes 60% to 70% of private equity-funding to infrastructure. Two of its recent infrastructure fund investments include the AIG Africa Infrastructure Fund and the South African Infrastructure Fund. Although many of AfDB's other fund investments do not resemble infrastructure by name, their portfolios predominantly contain investments that support the infrastructure sector.

The Islamic Development Bank has played a pioneering role by creating the Middle East's first infrastructure fund, the IDB Infrastructure Fund, which is focused on its 57 member countries. The IDB has plans to add a new multi-fund platform to substantially expand its private-equity investments in its member countries.

EIF, ADB, and MIF are all pioneering "clean tech" and new energy initiatives as part of their private-equity fund operations.

In Asia, 53% of the Asian Development Bank's private-equity financing in investee companies has been committed to infrastructure in the telecommunications, transport, and utilities sectors (ADB [2008]). Infrastructure investments have been particularly strong for ADB in India and other rapidly growing areas. Its three India-focused funds are the AIG Indian Sectoral Equity Fund, the Infrastructure Fund of India, and the IDFC Private Equity Fund II.

RATIONALE FOR EXPANSION INTO PRIVATE INFRASTRUCTURE FUNDS

The MDFI representatives interviewed cited a number of factors underlying the expansion into private infrastructure funds, including positive multiplier effects, efficient capital deployment, political risk cover, deal flow agglomeration, and encouragement of clean energy. These factors are discussed below, in the context of the infrastructure sector.

Multiplier Effects

Substantial multiplier effects can result when a multilateral development bank invests in a private infrastructure fund. An investment by a major MDFI provides the international community's "seal of approval," which enhances the ability of the fund to manage political risk, gives it credibility, and indicates positive developmental significance and good governance. Together, these signals serve as a positive catalyst to mobilize even larger amounts of debt and equity capital from pension funds, sovereign funds, and institutional investors. For example, ADB investments have mobilized an estimated $8.08 in equity capital for every dollar invested (ADB [2008]). This multiplier factor would be even larger if additional debt capital was also included in the calculation.

Enabling Efficient Capital Deployment

Another potential benefit of investing in infrastructure funds, as opposed to investing directly in infrastructure projects, is efficient deployment of capital. "MDFIs are inherently inefficient [in this respect]," noted an AfDB Private Sector Operations representative. "It takes us, relatively speaking, much more time to put together a transaction than a commercial bank." One of the reasons for this is that MDFI boards must approve every transaction, which often takes four to six weeks, greatly extending the time to complete a transaction. Several MDFIs view infrastructure funds as "wholesale vehicles" to invest capital. Furthermore, fund managers on the ground tend to be better equipped for deal sourcing and investment management in their particular markets because they have more specialized knowledge than development bankers, who must maintain a more regional scope.

Political Risk Cover

Infrastructure projects require direct or indirect collaboration between the public and private sectors. Thus, political risks are always a factor, especially in emerging countries where rule of law is weak and enforcement of contracts is unreliable. Empirical research shows that MDFIs can provide significant benefit to infrastructure projects by implicitly or explicitly providing political risk cover. Through their relationships with sovereign and sub-sovereign agencies, MDFIs can provide channels of dialogue and influence to protect against nationalization and creeping expropriation (Woodhouse [2005–2006], p. 121). MDFIs are also capable of working directly with governments to help create policies that will best promote private-sector development. By simultaneously investing and advising on policy reforms, an MDFI can have positive impacts on making emerging private-equity markets more reliable for private investors. A representative from the Asian Development Bank noted that the comparative advantage of the MDFIs is not actually in the supply of capital, where they have no inherent competitive advantage over other commercial banks, but in protecting against government intervention, making them more akin to (political) insurance companies.

Agglomeration of Market and Deal Flow Information

By investing across a portfolio of infrastructure funds, MDFIs put themselves at the hub of a network within which they gain access to rich proprietary information about local markets, deal flow opportunities, and pricing. Infrastructure funds typically expect to execute 10 to 20 deals over a three- to five-year period. Thus, an MDFI that has taken small limited partner positions across 20 private infrastructure funds can expect to see 200 to 400 deals that go to financial close, plus information about many other deals that do not go forward. Consequently, by setting up fund investment portfolios, MDFIs dramatically expand the number of agents they have on the ground and the reach of their information-gathering apparatus. Moreover, an MDFI's investment in a fund can increase deal flow for both sides of the transaction. A representative from the African Development Bank noted that it will often bring projects that require equity to its fund managers in the same way the fund managers will approach AfDB with projects that need extra debt financing. Co-investments are not uncommon.

Encouraging Clean Energy

Clean energy funds have become increasingly popular among MDFIs. For example, the Multilateral Investment Fund has invested in four clean energy funds in Latin America, initiating three of them itself. In 2001, the MIF invested $10 million in the $32 million FondElec Latin America Clean Energy Services Fund (FLACES). A MIF representative noted that the FLACES fund has played a fundamental role in the development of the energy service industry in Mexico. More recently, MIF has invested in the Central American Renewable Energy and Cleaner Production Facility (CAREC). CAREC is a $17 million mezzanine financing facility that has invested in small and medium-sized enterprises that employ proven clean energy technologies. According to an MIF representative, its clean energy fund investments have performed relatively poorly compared to other regional private-equity investments. The MIF feels that mezzanine structures are more appropriate for the sector. The Asian Development Bank has also played an active role in the clean energy sector and has recently initiated five funds totaling $100 million. Finally, the Islamic Development Bank has plans to initiate a clean energy fund for the Middle East in the near future. Despite the rising popularity of clean energy, MDFIs have struggled to find the best way to approach it. Due to the early stages of the sector, it is perceived to have higher risk, and financing structures are still evolving.

MANAGER SELECTION, FUND MANAGEMENT, AND FUND CREATION

There are two perspectives among MDFIs concerning manager selection. Some prefer to enhance the developmental impact of their activities by bringing new infrastructure managers to the market. For example, the African Development Bank often seeks to help indigenous African fund managers get started. Both ADB and IFC have noted cases in which they too have sought to bring new managers to market. For the most part, however, multilateral development finance institutions prefer to rely on proven fund managers with a tried-and-tested strategy and strong track record. The former director of private sector operations at the ADB is a proponent of repeating funds with the same manager, noting: "Your primary goal is to get the money properly invested in an emerging country. If you've got a good fund manager, it is irrelevant how many funds you do with them." In countries where private participation in infrastructure is just emerging, there may be few options other than to mentor new managers and develop new talent.

MDFIs also have different perspectives on whether they should partner closely with their fund managers or monitor them at arm's length. For example, the Islamic Development Bank prefers to be closely involved with its fund managers in setting fund strategy and making investment decisions. It has developed an autonomous management company, which allows it to closely oversee the investment policy of its largest private equity fund investment, the IDB Infrastructure Fund. The most involved MDFIs will sometimes take a share of the general partner or participate in profit sharing with the general partner. The IDB as well as the International Finance Corporation have taken such positions. As examples of a more hands-off approach, both AfDB and EBRD tend to rely heavily on their fund managers and limit their involvement to a fund's advisory board. For purposes of comparison, this more hands-off approach also typifies most U.S. pension funds. Despite general differences in where MDFIs reside along this continuum, most of them tailor the proximity of their interactions with fund managers to fit circumstances. For example, when ADB takes a more active role, it is typically done in order to achieve two goals: to encourage new fund managers to adopt industry best practices, and to ensure that the MDFI's governance policies trickle down to the projects in which the funds invest.

The MDFIs have, on occasion, created their own private infrastructure funds. According to the treasurer of IDB, principal sponsorship is now the bank's primary approach to private equity. In 2001, the Islamic Development Bank committed $100 million to the $730 million IDB Infrastructure Fund and took a majority stake in its Policy Management Company (PMC). The PMC, a unique structure that the IDB developed specifically for this fund, serves as a board to oversee the governance and investment policy of the fund. The role of the PMC includes monitoring compliance by the general partner, reviewing the performance of the general partner, and reviewing and approving all arrangements and transactions, as well as investigating and ruling on any potential conflicts of interest. The lead sponsors of the fund serve as board members of the company, and the PMC is entitled to a share of the fund's performance fee. The IDB plans to initiate a series of private-equity funds in the near future and has already committed to launching the IDB Infrastructure Fund II. It is expected to invest more than $200 million of its own capital in the fund and to continue using this successful PMC model in future.

In 2007, AfDB assisted in initiating the largest Pan-African infrastructure fund with the Public Investment Corporation of South Africa, Africa's largest pension fund manager. This fund mobilized $800 million of exclusively African resources for infrastructure projects. A representative from AfDB notes, however, that the bank generally does not initiate its own funds because of the intensive time, risk, and equity requirements of such endeavors.

THE CHALLENGES THAT MDFIs FACE IN BUILDING UP PRIVATE INFRASTRUCTURE INVESTMENT PROGRAMS

There are several challenges that restrict the growth of private-sector infrastructure fund investment programs within the MDFIs. First, some of these institutions have an internal conflict over MDFI-supported private-equity funds achieving supernormal profits on such investments because the MDFIs' primary goal is promoting development. Typically, MDFI boards are dominated by public sector officials, some of whom have an aversion to private-sector profits. A representative from a major MDFI noted the following: "The public-sector mind sees profits as a bad thing. Hence they are concerned when such funds achieve exuberant returns. From their perspective, profits represent gains from a zero sum game. At the same time, they remain anxious when they realize that the fund is underperforming. I would always say to them that I was not a profit maximizer but a profit satisfier." Secondly, MDFIs can face difficulty finding fund managers willing to work in less mature markets, where fewer potential portfolio companies exist and risks are much higher. The IDB Infrastructure Fund has been able to invest only 7% of the fund in very low-income countries. The Asian Development Bank has faced similar challenges retaining fund managers in emerging countries. Finally, the fact that most private infrastructure fund managers report only financial performance metrics means that it is difficult for MDFIs to assess developmental impacts such as enhancing infrastructure coverage, service quality, and access.

CONCLUSIONS

Based on the evidence presented in this study, we observe that private-equity fund structures represent an important new point of access for MDFIs into infrastructure projects. This phenomenon could have an important impact on emerging markets in Africa, Asia, Central Europe, Latin America, and the Middle East. With backing from multilateral development finance institutions, project sponsors that are arranging infrastructure financings will increasingly have access to equity capital from private infrastructure funds.

Several unanswered questions remain for future researchers to examine. What are the impacts of MDFI participation on fund performance? Are MDFI fund investments finding their way into projects of developmental significance, as opposed to just chasing returns? Is the trickle-down of MDFI social and environmental safeguards to fund managers actually working? And, do MDFIs need to create new developmental performance benchmarks to augment single-dimensional rate-of-return metrics commonly employed by private equity style funds?

ENDNOTES

[1]The 14 MDFIs that we identified are: African Development Bank, Andean Development Corporation, Asian Development Bank, Black Sea Trade and Development Bank, Central American Bank for Economic Integration, Eastern and Southern African Trade and Development Bank, Eurasian Development Bank, European Bank for Reconstruction and Development, European Investment Fund, Inter-American Investment Corporation (Inter-American Development Bank Group), International Finance Corporation, Islamic Development Bank, Multilateral Investment Fund (Inter-American Development Bank Group), and Nordic Development Fund.

[2]IIC is a member of the Inter-American Development Bank Group, it is a separate legal entity with different shareholders.

[3]MIF is a fund under management of the IADB, and is not a separate legal entity.

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