The emerging markets private equity industry has grown significantly over the past decade. Indeed, the eight largest multilateral development finance institutions (MDFIs) have committed more than $12.5 billion to private equity funds. Although seldom recognized, these institutions have grown to become some of the largest private equity fund investors in their respective regions of operation. This article offers a review of the universe of MDFI private equity fund investment programs and is organized around several research questions: To what extent are MDFIs now investing in private equity funds? How large are these programs relative to other MDFI private sector programs? Why have MDFIs established private equity fund investments and how do rationales differ across programs? In which countries are MDFIs focused on making fund investments, and why? And finally, how are managers selected, how are funds formed, and how has performance been measured? This study seeks to enhance awareness of MDFI investments in private equity funds, encourage best management practices for these investments, and enhance transparency of the financial and developmental impacts of MDFI investment programs.

For the purpose of this article, a multilateral development finance institution is defined as a public institution, funded and owned by multiple member countries, which provides financing to encourage economic development in a regional or global area of focus. This article evaluates only those institutions that have formerly held or currently hold investments in private equity funds.

PRIVATE EQUITY LITERATURE REVIEW

For the most part, the MDFIs resemble traditional commercial banks, which were the dominant organizational form in the financial markets during the period in which they were established. As reluctant as they (and all organizations) are to change, the multilateral development finance institutions have, nonetheless, adopted some new organizational forms, particularly the move to private equity, where they initially intended to play a catalyst role in mobilizing private capital. However, over the years, the MDFIs have established themselves as major investors in the private equity industry. While there are many types of private equity vehicles, the development institutions have mostly gravitated to the growth equity model, which seeks to invest in industries that drive innovation and economic growth and create new jobs and opportunities for their respective economies.

The growth of the private equity industry in the last 20 years has been dramatic.
According to Kaplan [2007], the industry grew from modest origins in the 1970s and 1980s, to more than $20 billion raised in 1995, $80 billion in 2000, and more than $150 billion in 2006. As a result of this growth, private equity funds—including venture capital, mezzanine, infrastructure, buyout, and other fund styles—have been extensively studied. An early and comprehensive overview article by Fenn, Liang, and Prowse [1995] defines the organized private equity market as “professionally managed equity investments in the unregistered securities of private and public companies.” In a recent interview, Kaplan [2007] suggests that the growth of private equity has been driven by four factors: high early returns, cheap debt from lenders, attractive spreads between earnings yields and interest rates, and receptivity of public company executives to being taken private. One of the principal issues with private equity is its illiquidity, given that these investments are not traded on the public markets. However, since the mid-1990s, the formation of a large secondary market with specialist investors focused on negotiated buyout of limited partner positions has somewhat resolved the liquidity challenge (DePonte [2007]).

There is a small but growing body of literature regarding private equity in developing markets. Pissarides [1999] shows that as early as 1999 the European Bank for Reconstruction and Development (EBRD) was pursuing investments in private equity funds focused on enhancing the development of small and medium enterprises (SMEs), particularly in difficult environments with weak financial markets such as the Central and Eastern European countries, where SMEs faced a liquidity constraint. In an unpublished working paper prepared for MIT in 2003 titled “Equity in the Developing World: The Determinants of Transaction Structures,” Lerner and Schoar [2003] find that across developing countries, common law countries tend to attract larger funds with more complex transactional structures than countries that lack a strong rule of law tradition. Given that transparency is one of the major issues facing emerging countries, one of the challenges for the multilateral development finance institutions is how to assess the trustworthiness of the parties with which they wish to work. Strikingly, a study of more than 100 Spanish private equity funds found that funds are more likely to signal operational efficiency to the market when they raise capital from private investors than when they raise capital from government investors (Balboa and Marti [2006]). There is an extensive body of articles that delve into the profitability of private equity investments. A survey undertaken by Phalippou [2007] summarizes the issue of risk/reward and fee structures. A “large N” study of 1,329 mature private equity funds carried out by Phalippou and Gottschalg [2007] suggests that, gross of fees, these funds outperform by 3% per year with respect to the S&P 500. However, on a net-of-fees calculation they underperform by 3% per year. Kaplan and Schoar [2005] reached similar conclusions and also found substantial heterogeneity in returns across funds as well as a strong persistence of returns across subsequent funds in a partnership. In a 2006 study, Phalippou and Zollo show that downturns in business and stock market cycles have significant negative impacts on private equity returns, as do inexperienced fund managers and smaller fund size. Diller and Kaserer [2008] also found that returns are positively correlated with a fund manager’s skill and experience, and negatively correlated with stand-alone investment risk and total fund inflows. Leeds and Sunderland [2003] show that private equity funds in emerging markets have underperformed during the 1990s relative to developed country funds. They identify low standards of corporate governance, dysfunctional capital markets, and limited legal recourse as the primary reasons for underperformance.

INTENDED CONTRIBUTION OF THIS STUDY

While a large number of articles review the growth, evolution, and performance of the private equity industry in emerging markets, we are unaware of any study that has systematically examined the important role of multilateral development finance institutions in the private equity industry. To address this gap, this article appraises the role of MDFIs in the establishment of private equity in emerging markets and examines how MDFIs have expanded beyond their traditional missions as lending institutions. These trends—and their identification—are believed to have important implications for developing country officials, MDFI board members, and private equity fund managers.

THE STUDY’S APPROACH

Fourteen multilateral development finance institutions that currently hold or have formerly held investments in private equity funds were initially identified.
Of these, we selected the eight with the largest private equity programs within their respective regions of operation.

The eight MDFIs that we sampled are listed in Exhibit 1. Interviews were conducted between October 1 and November 15, 2008. Informants included senior economists, directors of private equity fund programs, and private equity investment professionals.

We are aware that many bilateral development agencies hold private equity fund investments (including BIO, CDC, DEG, FINNFUND, FMO, Norfund, OPIC, Proparco, SIFEM, and SWEDFUND) but they fall outside the scope of the present study.

**FINDINGS**

Exhibit 1 provides a summary of the eight MDFIs studied, their regions of operation, the number of private equity investments that they currently hold in their portfolios, the total value of their private equity commitments, and the primary strategy or rationale of each of the MDFIs for establishing private equity investment programs.

### The Scale of MDFI Private Equity Programs

Exhibit 2 displays the overall size of the various MDFI private equity investment programs. The sizes are based on commitments to funds. Currently, multilateral development finance institutions have committed more than $12.5 billion of capital to private equity funds. However, it can often take a private equity fund several years to draw down committed capital.

**Typical fund stake.** Formal policies within the MDFIs typically limit them to investing in no more than 20% of a fund’s committed capital. However, they often tend to take smaller stakes than this formal limit. A few exceptions exist. For example, the ADB generally

### EXHIBIT 1

**Multilateral Development Finance Institutions with Private Equity Operations**

<table>
<thead>
<tr>
<th>MDFI</th>
<th>Acronym</th>
<th>Region</th>
<th>Current PE Fund Investments (#)</th>
<th>Current PE Fund Commitments (US$ mn)</th>
<th>Primary Strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>African Development Bank</td>
<td>AfDB</td>
<td>Africa</td>
<td>9</td>
<td>155</td>
<td>Infrastructure development</td>
</tr>
<tr>
<td>Asian Development Bank</td>
<td>ADB</td>
<td>Asia</td>
<td>40</td>
<td>763</td>
<td>Financial market development</td>
</tr>
<tr>
<td>European Bank for</td>
<td>EBRD</td>
<td>Central</td>
<td>100+</td>
<td>1590</td>
<td>Restructuring, transition, and efficiency</td>
</tr>
<tr>
<td>Reconstruction and</td>
<td></td>
<td>Europe &amp;</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Development</td>
<td></td>
<td>Asia</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>European Investment Fund</td>
<td>EIF</td>
<td>Europe</td>
<td>266</td>
<td>5602</td>
<td>Support to SMEs, entrepreneurship</td>
</tr>
<tr>
<td>Inter-American Investment Corporation*</td>
<td>IIC</td>
<td>Americas</td>
<td>16</td>
<td>31</td>
<td>Support to SMEs, entrepreneurship</td>
</tr>
<tr>
<td>International Finance</td>
<td>IFC</td>
<td>Global</td>
<td>150</td>
<td>2200</td>
<td>Financial market development</td>
</tr>
<tr>
<td>Corporation**</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Islamic Development</td>
<td>IDB</td>
<td>Islamic</td>
<td>11</td>
<td>1500</td>
<td>Infrastructure development</td>
</tr>
<tr>
<td>Bank</td>
<td></td>
<td>Countries</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Multilateral Investment</td>
<td>MIF</td>
<td>Americas</td>
<td>40</td>
<td>119</td>
<td>Support to SMEs, entrepreneurship</td>
</tr>
</tbody>
</table>


**Notes:** *IIC is a member of the Inter-American Development Bank Group; it is a separate legal entity with different shareholders; **Member of the World Bank Group; ***MIF is a fund under management of IADB and is not a separate legal entity.*
takes a 25% stake in a fund, while the MIF, which invests in small funds, takes up to a 50% stake.³

Multiplier effect. There is a large multiplier effect when an MDFI invests in a private equity fund. Generally, more than five times the amount of capital committed by the MDFI will be mobilized through other institutional investors. An investment by a major multilateral development finance institution can provide the international community’s “seal of approval,” which enhances the prestige of a fund, gives it credibility, and indicates good governance and positive developmental significance. Together, these positive signals encourage other investors to enter the fund and make it easier for the fund to attract debt financing.

For example, the Asian Development Bank’s funds have mobilized an estimated $8.08 for every dollar that the ADB has invested (Asian Development Bank [2008]). The ADB describes this effect on their website: “ADB’s presence in a fund provides comfort to private investors: they know that the legal structure of the fund will protect shareholders in the context of Asia’s emerging economies, and that the fund has undergone thorough due diligence.”⁴

It is easier for a private equity fund with multilateral equity to increase debt financing because potential lenders see the presence of the MDFI as a form of political risk mitigant. When including this debt financing, the multiplication factor becomes even larger. Thus, an MDFI’s investment in a private equity fund serves as a catalyst to mobilize even larger amounts of capital—both debt and equity. Assuming a multiplier of five implies that MDFIs have mobilized approximately $62.5 billion in capital into private equity funds.

Evolution of Private Equity Programs

The ADB and the IFC were among the first multilateral development finance institutions to invest in private equity funds, and have been doing so since the 1980s. ADB made its first private equity fund investment in 1983 (Asian Development Bank [2008]). IFC made its first private equity fund investment in the mid-1980s.
Most of the other MDFIs began sparsely investing in private equity funds in the 1990s. 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. In their early stages, these operations were ad hoc and tended to have little formal support structure. For the most part, no formal departments existed to oversee these investments, which were made largely on an opportunistic basis. With little internal structure, the MDFIs lacked the capacity to formulate advanced strategies for their private equity fund investments.

The EBRD was one of the first multilateral development finance institutions to formalize their private equity fund operations. In 1997, they moved their equity funds team explicitly into the financial institutions business group. In 2000, the International Finance Corporation formalized its activities by creating a Private Equity and Investment Funds Group. In late 2002, Asian Development Bank created a Funds Division to select and manage its investments in private equity funds. The MDFIs have continued to increase the size of these programs and to explore new and creative methods for sourcing, structuring, managing, and exiting their investments. This, has not been an easy process for these institutions. For some MDFI board members, private equity has been somewhat risky proposition, and every several years private equity divisional managers have had to justify their private equity operations to their boards.

Over the last few years, the private sector operations of multilateral development finance institutions have expanded rapidly. ADB has had one of the fastest-growing programs. Its commitments to the private sector grew by a factor of 40 in six years, from $58 million in 2001 to $2.3 billion in 2008. At AfDB, almost a third of new investment activity today is through the private sector. Starting in 2007, the Inter-American Development Bank (IADB) and the African Development Bank also began periods of rapid growth in private sector financings. The EBRD has the largest private sector financing volume because, unlike the other MDFIs, its charter requires the bank to provide 60% of its financing to the private sector and 40% to the public sector. In recent years that ratio has been closer to 80% private sector, 20% public sector.

Private sector funds departments have been growing rapidly in the multilateral development finance institutions. As Exhibit 3 shows, MDFIs overall currently channel between 5 and 30% of their private sector investments through private equity funds.

The Rationales for MDFI Private Equity Fund Investments

There is a striking variety of rationales for why multilateral development finance institutions have turned to private equity funds. Exhibit 4 depicts some of the most commonly cited reasons. The list is rank-ordered based on the relative frequency and primary importance of the different rationales, as identified during interviews with MDFI representatives and in MDFI documentation.

The original mission of the MDFIs was to contribute to development by financing public sector organizations and projects. Only recently have they begun to intently expand into the private sector. At the beginning private sector involvement was limited almost entirely to the form of debt. The three most common reasons for investing in private equity funds were: developing financial markets; supporting infrastructure development; and promoting the growth of small and medium enterprises, innovation, and entrepreneurship.

Developing financial markets. The MDFIs have recognized that private equity funds are a means to support the development of emerging financial markets. Equity financing plays an essential role in the development of many sectors, including infrastructure and SMEs. As previously noted, equity can also improve a company’s access to debt financing and, therefore, serve as a catalyst for additional investment. However, equity investments in emerging markets have high associated risks. According to a regional executive in IFC’s Private Equity and Investment Funds Group, “domestic private sector lending organizations generally have neither the risk appetite nor the risk evaluation capabilities to invest in private equity in emerging markets.” By supporting private equity funds, a multilateral development finance institution can demonstrate to the private sector that private equity is a viable form of investment and can help to ensure that fair returns are realized. Some MDFIs have even noted their capacity to reduce risk within emerging financial markets. Through their relationships with sovereign and sub-sovereign agencies, MDFIs can offer implicit political risk mitigation to protect against creeping expropriation and government intervention (Woodhouse [2005–06]). MDFIs also have
**EXHIBIT 3**
MDFI Allocations to Private Equity Funds

![Bar chart showing MDFI allocations to private equity funds.]


**EXHIBIT 4**
Rationales For MDFI Private Equity Fund Investments

<table>
<thead>
<tr>
<th>Rationale</th>
<th>ADB</th>
<th>AfDB</th>
<th>EBRD</th>
<th>EIF</th>
<th>IIC</th>
<th>IFC</th>
<th>IDB</th>
<th>MIF</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Developing financial markets</td>
<td>P</td>
<td>S</td>
<td>S</td>
<td>P</td>
<td>S</td>
<td>S</td>
<td>P</td>
<td>S</td>
<td>7</td>
</tr>
<tr>
<td>Supporting infrastructure development</td>
<td>S</td>
<td>P</td>
<td>P</td>
<td>P</td>
<td>P</td>
<td>P</td>
<td>P</td>
<td>S</td>
<td>7</td>
</tr>
<tr>
<td>Promoting growth in SMEs, innovation and entrepreneurship</td>
<td>S</td>
<td>S</td>
<td>P</td>
<td>P</td>
<td>P</td>
<td>6</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Encouraging clean energy</td>
<td>S</td>
<td>S</td>
<td>S</td>
<td>P</td>
<td>P</td>
<td>P</td>
<td>P</td>
<td>P</td>
<td>6</td>
</tr>
<tr>
<td>Enabling efficient capital deployment</td>
<td>S</td>
<td>S</td>
<td>S</td>
<td>P</td>
<td>P</td>
<td>P</td>
<td>P</td>
<td>P</td>
<td>6</td>
</tr>
<tr>
<td>Fostering restructuring, transition, and efficiency</td>
<td>S</td>
<td>S</td>
<td>S</td>
<td>P</td>
<td>P</td>
<td>3</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Providing (implicit) political risk cover to mobilize private capital</td>
<td>S</td>
<td>S</td>
<td>S</td>
<td>S</td>
<td>S</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Earning high investment returns</td>
<td>S</td>
<td>S</td>
<td>S</td>
<td>P</td>
<td>P</td>
<td>P</td>
<td>P</td>
<td>P</td>
<td>6</td>
</tr>
<tr>
<td>Achieving good governance, positive social and environmental impact</td>
<td>S</td>
<td>S</td>
<td>S</td>
<td>S</td>
<td>S</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Catalyzing foreign investment</td>
<td>S</td>
<td>S</td>
<td>S</td>
<td>P</td>
<td>P</td>
<td>P</td>
<td>P</td>
<td>P</td>
<td>6</td>
</tr>
<tr>
<td>Creating jobs</td>
<td>S</td>
<td>S</td>
<td>S</td>
<td>P</td>
<td>P</td>
<td>P</td>
<td>P</td>
<td>P</td>
<td>6</td>
</tr>
</tbody>
</table>

*Notes: P = Primary Rationale (Score = 2); S = Secondary Rationale (Score = 1).*

*Sources: Interviews with MDFIs, MDFI websites, MDFI annual reports.*
the capability to work directly with governments to help them enact policies that will best promote private sector development. For example, the Multilateral Investment Fund has worked with the Brazilian government to establish the policy environment for private equity investment. By simultaneously investing and promoting policy changes, an MDFI can have significant effects on the development of emerging private equity markets.\(^8\)

One important component of developing financial markets lies in establishing banks, stock markets, and financial services firms. As with infrastructure projects, the implicit political risk insurance provided by MDFIs can benefit financial firms, which must interact with local ministries of finance and central banks on a regular basis. A financial institution can also serve as an upstream catalyst for private sector development. The Asian Development Bank devotes a significant portion of its private equity program to investments in financial institutions. The African Development Bank and the International Finance Corporation have both discussed possibilities of investing in African commercial banks to reinforce their capital structures. The other MDFIs, however, have generally been less involved in the financial sector, mostly due to a lack of private equity funds in emerging markets that invest in financial institutions. For this area to become larger in the future, more emerging market funds with a specialty in incubating financial firms will need to develop.

**Promoting growth in small and medium enterprises.** Multilateral development finance institutions often believe that providing support to small and medium enterprises can be crucial to a region’s development. However, overseeing many direct equity investments in SMEs would be tactically difficult for many of the MDFIs given the intense requirement for their operational and strategic involvement. For this reason, MDFIs often turn to funds to manage their SME investments. The European Union established the European Investment Fund for the sole purpose of supporting small and medium enterprises. EIF has grown to become the largest MDFI player in private equity. According to its website, SMEs comprise 99% of businesses in the EU and account for 75 million jobs.\(^9\) EIF differs from other MDFIs covered in this study because it invests heavily in developed economies.

The mission of Multilateral Investment Fund (a fund under management of the Inter-American Development Bank) is centered on supporting SMEs. Thus, its private equity operations focus entirely on this sector. MIF has sought to establish a venture capital industry in Latin America, where little venture funding has been available to date. It has been particularly successful in Brazil, where it has served as an investor and actively promoted policy changes to support the industry. This culminated in the creation of a fund of funds with an arm of the Brazilian government. According to a MIF representative, there are now over 50 fund managers in Brazil. The venture capital funds in which MIF has invested are young companies in various sectors. Unlike traditional VC funds, these funds do not necessarily invest in high-technology companies. Because debt markets in Latin America are small, equity can play a crucial role in the development of small and medium enterprises. In future, MIF hopes to expand to other countries in the region that lack venture capital industries. It is currently working with the governments of Peru and Colombia to assist them in the development of policies to encourage entrepreneurship.

Other multilateral development finance institutions also allocate a significant amount to SME funds. A representative from the IFC noted that SME funds are a main area of focus for its private equity operations. According to the ADB Special Evaluation Study, 47% of private equity investments in the portfolio of the Asian Development Bank are in SME funds (Asian Development Bank [2008]). The boards of the multilateral development finance institutions often struggle with the idea of approving investments in SMEs because of the size and risk profile of such investments. A representative from one of the MDFIs noted that, “While the board supports SMEs in an abstract sense, they often find it difficult to live up to such commitments; I remember one particular meeting where we had to justify an investment in a company manufacturing hair dryers.” Nevertheless, investing in SMEs through funds is often easier for a private sector team to manage than investing into a large number of SMEs. However, SME funds may be cut back in the face of the current financial crisis as the market and financial risks increase and their returns suffer.

**Supporting infrastructure development.** Infrastructure projects always require, either directly or indirectly, collaboration between the public and private sectors. Thus, the political risk mitigation implicitly or explicitly provided by an MDFI can significantly benefit infrastructure projects. By investing in infrastructure projects, an MDFI can serve as a catalyst for the development of other private sector enterprises that depend upon that infrastructure. This is a particularly strong argument for Africa, which
lags far behind the rest of the world in infrastructure development. For this reason, the African Development Bank places specific emphasis on supporting infrastructure. According to its 2007 Annual Report, 74.8% of total AfDB loan and grant approvals during that year were dedicated to infrastructure. According to an AfDB representative, the institution devotes 60 to 70% of private equity funding to infrastructure. Although many of these funds are not infrastructure funds by name, their portfolios predominantly contain infrastructure investments. The same is somewhat true for the Asian Development Bank. According to the Special Evaluation Study of Private Equity Fund Operations, 53% of total private equity financing in investee companies has gone to infrastructure in the telecommunications, transport, and utilities sectors (Asian Development Bank). The ADB has found infrastructure funds to be particularly strong investments in India and other rapidly growing areas. In addition, infrastructure investment is politically easier for multilateral development finance institutions because this sector is generally considered to be a responsibility of the public sector. As a result, MDFIs are far more comfortable investing in it.10

Encouraging clean energy. In addition to the provision of traditional infrastructure, clean energy funds have become increasingly popular among MDFIs. The Multilateral Investment Fund has invested in four clean energy funds in Latin America, three of which it initiated. The Islamic Development Bank has plans to initiate a clean energy fund for the Middle East in the near future. The Asian Development Bank has also played an active role in the clean energy sector and has recently initiated five such funds ($100 million in total). 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 as higher risk and financing structures are still evolving. A MIF representative noted that their clean energy fund investments have performed relatively poorly compared to other regional private equity investments. High overhead, common among clean energy companies, can rapidly erode equity. For this reason, the MIF has found mezzanine financing more successful in this sector. In the future, it plans to support the industry through mezzanine and other quasi-equity structures.

Enabling efficient capital deployment. Three of the MDFIs in the sample—ADB, AfDB, and EBRD—stated that efficient deployment of capital to unlisted enterprises is an important rationale for fund investment. A representative from Private Sector Operations at the African Development Bank has noted that MDFIs are inherently inefficient in this respect because, they take relatively more time to put together a transaction than a fund manager. The MDFIs are, after all, state-owned organizations, whose procedures are centered on public sector norms. Only a few, including EBRD, have moved toward a much greater private sector focus. Thus, for example, they must go to their boards to approve all transactions, which is highly unusual in the private sector. This process often takes at least four to six weeks, greatly extending the required transaction processing time. Because of this inherent inefficiency it is often difficult for MDFIs to make equity investments, which require significant time and resources to oversee. As one MDFI representative described, “funds can serve as wholesale vehicles” to invest capital more efficiently. Furthermore, fund managers on the ground often have a closer and more specialized knowledge of a country’s markets than the development bankers, who must maintain a larger regional scope. Thus, the fund managers tend to be better equipped for deal sourcing and investment management in their particular markets.

Although the MDFIs interviewed for this study brought up a number of common reasons for private equity investing, several of them also stated rationales that are salient only to their particular organization. As previously mentioned, the Asian Development Bank places particular emphasis on supporting financial institutions and on their ability to offer implied political risk mitigation (which they believe underlies their investments in both infrastructure projects and investments in financial institutions). On the whole, its private sector financing is equally divided between these two sectors. The AfDB and IDB tend to prefer infrastructure funds. EIF and MIF invest in private equity to support small and medium enterprises. The EBRD is focused primarily on encouraging restructuring, transition, and efficiency in the Eastern European countries, which have a relatively short history of private sector development and capitalist institutions. Other stated rationales include creation of jobs, attraction of foreign investment, and promotion of good governance. Strikingly, only one MDFI stated that achieving a high rate of return was an explicit objective. Given the generally similar goals of the MDFIs, it is an unexpected outcome of this study to see this high degree of variance in their rationales for private equity investment.
Geographic Distribution

Globally, funds in Asia and Europe tend to get more private equity funding from MDFIs than funds on other continents. For example, IFC’s 2007 portfolio contains 38 funds in Asia, 34 in Europe and Central Asia, 25 in Latin America and the Caribbean, 21 in Africa, 5 in the Middle East and North Africa (MENA), and 4 in global funds. Exhibit 5 shows the geographic distribution of the ADB and EBRD portfolios, in the Asian and Central European regions respectively. China and India tend to attract more than half of all private equity fund investments in ADB’s portfolio, and Poland and Russia have captured a similar proportion of investment in EBRD’s portfolio.

**Europe.** Two of the largest MDFI private equity programs focus on European markets. EIF, which currently holds the largest program, has committed over EUR 4.4 billion across 266 European funds. The EIF invests predominantly in venture capital to further its mission of supporting small and medium enterprises. EBRD holds the second largest private equity funds program. With commitments of over $1.5 billion, the EBRD is the largest private equity funds investor in its region, which includes central Europe as well as central Asia.

**Asia.** The Asian Development Bank holds a portfolio of about 40 active funds with an approved value of $763 million, making it the largest private equity fund portfolio in Asia. According to a representative from the International Finance Corporation, about 30% of the IFC’s fund investments are in East Asia.

**Americas.** The Inter-American Investment Corporation and the Multilateral Investment Fund hold small private equity fund portfolios. According to the 2007 IIC annual report, the institution holds $30.6 million in 16 investment funds. A MIF representative interviewed for this study reported that the Fund currently holds commitments of $119 million in about 40 venture capital funds.

**Africa.** The multilateral development finance institutions have been less active in the relatively young African private equity market. The African Development Bank, the most active MDFI in the region, has invested in about 40 funds. According to its 2007 Annual Report, the AfDB held investments in seven funds, for a total value of $155 million. An AfDB representative noted that the investment program has been expanding rapidly. From June to October, 2008, the bank invested in five to six funds, averaging approximately $30 million per fund. The IFC is currently making efforts to expand operations in Sub-Saharan Africa as part of an initiative to move into frontier private equity markets.

**Middle East.** MDFI private equity fund programs are growing rapidly in the Middle East. The Islamic Development Bank played a pioneering role in private equity development in the region, investing $100 million in the Middle East’s first infrastructure private equity fund. IDB currently holds investments of about $1.5 billion in 11 private equity funds and has also committed a substantial amount to a second infrastructure fund, which it is about to initiate. Following this second infrastructure fund, IDB plans to initiate a

![Exhibit 5](image-url)
series of private equity funds in its region of operation. Given the fact that equity is the most Sharia-compliant of all financial instruments, private equity funds work particularly well for IDB, which encourages Sharia-compliant financing.

**Global.** The IFC holds the second largest MDFI private equity fund program. Its private equity investments are globally diversified. According to a representative interviewed for this study, the corporation currently holds commitments of about $2.2 billion in 150 private equity funds. The International Finance Corporation also holds stakes in a number of fund management companies and has supported the creation of EMPEA (the Emerging Markets Private Equity Association).

**Middle-income country concentration.** Good investment opportunities with sizable companies in the poorer “frontier countries” are difficult to find. As a result, the private equity fund distributions of the multilateral development finance institutions tend to be skewed toward middle-income regions, where fund managers are more willing to work.

For example, as of 2006, the EBRD had committed 30% of its private equity funding to Poland and 24% to Russia, while other relatively less developed countries in EBRD’s region of operation received much less funding. The Asian Development Bank’s portfolio shows a similar geographic concentration. According to the Special Evaluation Study, 78% of the ADB’s private equity investments are distributed across four countries, with 51% of its private equity investments in China and India alone (Asian Development Bank [2008]). A former ADB official noted that the bank had particular difficulty in 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 African Development Bank does not invest in single country funds because of high risk concentration.

An interesting variation occurs when some MDFIs invest in the more developed countries. When fund managers create regional funds they insist on being able to invest small portions of the funds in the more developed countries as a sweetener to the overall package. The MDFIs accept this as a needed enticement, but typically restrict this portion to 10 to 25% of the overall fund.

**MDFI Investment Professionals**

The International Finance Corporation has the largest team of investment professionals (15 persons). Two of its professionals were formerly employed by World Bank’s pension fund, where they gained exposure to fund investments in developed countries. The ADB has a team of three professionals working entirely on funds and the EBRD has a team of eight professionals. The African Development Bank’s funds team totals six to seven investment professionals, one of whom is a private equity specialist. The others are sector specialists who look at funds that fall within their area of expertise.

Exhibit 6 demonstrates that there is a wide variation in the amount of capital committed per investment professional at each of the MDFIs. This variation occurs for a number of reasons. One of these reasons is the differences in the ages of programs. For example, the EBRD has had a formal private equity program since 1997 and, therefore, has had much more time to build up commitments than the AfDB, which has made a significant portion of its fund investments in the past six months. Differences in the type of private equity fund also account for the variation. The Multilateral Investment Fund, for example, invests predominantly in venture capital funds, which typically are much smaller than infrastructure funds. At $40 million per investment professional, the MIF’s program would seem heavily staffed. However, the MIF has invested in approximately 40 venture capital funds, which is a large absolute number.

It is often difficult for MDFIs to recruit investment professionals with experience in private equity because they cannot offer the high salaries typical of the private equity industry. Furthermore, MDFI investment professionals do not receive carried interest, the performance-based compensation that managers of private equity funds are accustomed to receiving. As a consequence, it can be difficult for MDFIs to retain top talent, although they do tend to serve as incubators for future leaders in the private equity industry.

**Manager Selection**

There are two lines of thought among MDFIs when selecting a fund manager. First, some MDFIs like to work with new fund managers because they feel that there is added development impact when they bring a new man-
ager to the market. For example, AfDB often likes to help indigenous African fund managers enter the industry. Both ADB and IFC have noted cases in which they too have sought to bring new managers to market. For the most part, however, MDFIs prefer to rely on proven fund managers with a track record of successfully investing capital and with a tried-and-tested strategy. The former director of private sector operations at the ADB has always been a proponent of repeating funds with the same manager, believing that the primary goal is to properly invest the money in an emerging country and that it is irrelevant how many funds you do with a particular manager as long as the manager has delivered positive results in past funds. However, the ADB’s board has argued to limit investments with a given fund manager to three rounds.

In a 2003 presentation on private equity funds, Teresa Barger of the International Finance Corporation made the following statement about the importance of picking a skilled fund manager: “Fund management is all about value addition. Only successful managers have a development impact by building great companies.”

Role in Fund Management

Today there are two predominant models that MDFIs employ to manage their private equity fund investments. The first is the direct-involvement model, which entails a close partnership between fund managers and MDFIs to set fund strategy and make investment decisions. The Islamic Development Bank provides perhaps the clearest example of this model. It has developed an autonomous management company that allows it to closely oversee the investment policy of its largest private equity fund investment, the IDB Infrastructure Fund. IDB plans to use this structure in future funds and may also initiate internally managed private equity funds.

The most involved MDFIs will sometimes take a share of the General Partner or participate in profit sharing with the General Partner. IDB and IFC have both taken such positions.

In middle-income markets, where private equity is a relatively new or unknown industry, local managers probably have had little experience. In such cases, MDFIs that have worked with hundreds of funds can often offer essential mentorship to fund managers as they commence operations.

The second is the hands-off model, which involves passive investments by MDFIs with trusted fund managers. The African Development Bank, the European Bank for Reconstruction and Development, and the International Finance Corporation generally employ this model, which tends to rely heavily on fund managers.
limiting the MDFI’s involvement to the funds advisory board. The AfDB has noted that it is not necessary to be on a fund’s investment committee to improve deal flow for the fund. Even without such a position, AfDB has been able to connect fund managers with potential investment opportunities. The hands-off model has also proven to work well for pension funds and other institutional investors that have smaller teams of investment professionals, as well as for investors entering a new sector (such as clean-tech) with which they are not familiar.

The Asian Development Bank tends to fall at a point on the continuum between the direct-involvement and hands-off models. According to ADB, its strategic objective for investment operations is “to be an active investor, with an active approach to corporate governance and environmental standards.” Private equity funds are also expected to help ADB in implementing these objectives. The ADB takes a more active role only in order to encourage new fund managers to adopt industry best practice or to ensure that the MDFI’s governance policies trickle down to the projects in which the funds invest.

Opinions are mixed with respect to taking seats on the investment committees. The IFC and AfDB used to hold seats, but, they concluded that their position on the investment committee could be detrimental to the fund and their relationship with the fund manager. Typically, a seat on the advisory board is a minimum requirement for a multilateral development finance institution to invest in a fund, and is viewed as providing close-enough contact that the MDFI can effectively leverage its relationships to provide deal flow and political risk cover.

Some MDFIs prefer to make direct equity investments rather than investments in private equity funds. This approach eliminates the layer of fees paid to external fund managers, but it requires that the MDFI have a much larger and experienced investment staff as well as a higher risk appetite. The 2007 IFC Annual Report indicates that IFC tends to follow this approach, investing only a portion of its private sector financing into private equity funds and a much larger proportion into direct equity investments. For a multilateral development institution that wants to pursue a direct investment strategy, the benefit of investing in funds (even if these investments are relatively small in proportion to their portfolio) is that relationships with fund managers can generate many co-investment opportunities that the MDFI may not otherwise have access to.

**Fund Creation by MDFIs**

The MDFIs, on occasion, have created their own private equity funds. According to the treasurer of the Islamic Development Bank, principal sponsorship is now the bank’s primary approach to private equity. In 2001, the IDB played a pioneering role by creating the Middle East’s first infrastructure fund, the IDB Infrastructure Fund. IDB committed $100 million to the $730 million fund. It also took a majority stake in the Policy Management Company (PMC) of the fund. The PMC, a unique structure, which IDB developed specifically for this fund, serves as a board to oversee the fund’s governance and investment policy. 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 any 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. They have already committed substantial amounts of funds to the IDB Infrastructure Fund II and plan to continue using this successful PMC model for future funds.

The AfDB and the IFC, in collaboration with the Gates Foundation, recently created their own health fund—the Equity Vehicle for Health in Africa. In 2007, the AfDB also 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. An AfDB representative notes, however, that the bank generally does not initiate its own funds because the process is both time and resource intensive.

The EBRD served as a principal sponsor for 18 funds in regions with limited private equity markets. The EBRD usually committed about 90% of equity capital to these funds. Since 2002, however, EBRD has stopped initiating its own funds. The Multilateral Investment Fund initiates funds regularly. When it recognizes a particular sector or region in Latin America that needs venture capital funding, the Fund will send out a call for proposals and invest in the fund manager that responds
with the most promising business plan. Other MDFIs generally have avoided the creation of funds because of the intensive time, risk, and equity requirements of such endeavors.

**Collaboration Between MDFIs**

The MDFI representatives interviewed for this study acknowledged that other multilateral and bilateral development finance institutions are typically their primary co-financing partners for private equity funds. An AfDB representative noted that development finance institutions operate as “a bit of a pack.” For example, the Asian Development Bank often co-finances funds with European bilateral development finance institutions that like to take part in development transactions in Asia, but have less access to deal flow than ADB. Thus, when ADB discovers a promising private equity fund, it often passes information to the Association of European Development Finance Institutions (EDFI), an umbrella organization of DFIs in Europe. EDFI shares the information with its member organizations. The ADB also invests in funds brought to their attention by other MDFIs. Recently, it initiated a $500 million Asia-focused infrastructure fund in collaboration with the Islamic Development Bank. Public pension funds and sovereign wealth funds were also mentioned as co-financing partners by representatives of several MDFIs.

MDFIs often co-finance projects with the private equity funds that they invest in. An MDFI’s investment in a fund can increase deal flow for both sides of the transaction. An AfDB representative noted that the bank will often bring projects that require equity to fund managers. In the same way, the fund managers will approach AfDB with projects that need extra debt financing.

**Performance**

The high returns (relative to conventional lending) provided by private equity funds seem to suggest yet another reason why multilateral development finance institutions have continued to allocate more money to the asset class. The business models of the MDFIs require that they generate moderate return on investments, but at the same time limit their exposure to risk. The private sector operations of the MDFIs make a limited number of direct equity transactions on their own each year. The diversification provided by a private equity fund reduces the typical risk associated with equity investment, but at the same time provides higher returns than the interest income on debt financing that the MDFIs have traditionally earned.

There is often some internal conflict within MDFIs over highly profitable investments, such as private equity funds. A representative from a major MDFI noted that, due to the latent public-sector perception that profits are bad, there may be concerns when the funds achieve very high returns because they tend to see profits as gains from a zero sum game. At the same time, however, they become anxious when the funds underperform.

The ADB’s investments into funds were capped by a charter provision that placed a very tight ceiling on the use of equity. No other MDFI imposes such a restriction. The ADB also had success in investing directly in infrastructure projects and thus its board, until recently, didn’t see a need to work closely with infrastructure funds.

An AfDB representative interviewed for this study noted that the bank has seen an average IRR between 15 and 20%. AfDB attributes some of their success to date to rapid growth in Africa. Their portfolio is also relatively young and therefore untested.

The IDB has made performance a priority in selecting private equity funds for investment. However, developmental and social objectives are also important, and some of its private equity profits are directed into charitable efforts such as the building of schools and hospitals.

In contrast, the EBRD program demonstrated poor performance in its early stages. According to the ADB Special Evaluation Study, as of 2003, the EBRD program had failed to cover risk-adjusted costs of capital (Asian Development Bank [2008]). Recently, however, the program seems to have turned around. As of 2006, the internal rate of return stands at 13.2%.

While the IFC does not release performance data, an IFC representative noted that the performance of their funds improved dramatically after the formal creation of the funds group in 2000. Exhibit 7 provides an overview of the performance of MDFI private equity fund programs.

Conventional private equity fund managers are judged solely on their financial performance, typically reported as an internal rate of return. However, in the case of MDFIs, the mission statements require that they
also consider the nonfinancial developmental impact of their investments.

Unfortunately, the rationales of most MDFI private equity fund investment programs (see Exhibit 4) are far more complex than the basic rate of return performance data reported by private equity fund managers. Few private equity funds track performance on metrics such as financial market development, development of SMEs, and improvement in infrastructure quality and coverage. If MDFIs were serious about transferring their developmental missions to the private equity funds in which they invest, they would need to establish a quantifiable framework or set of metrics against which to measure the social performance of their fund investments. Made available to the public, such information would ensure that MDFIs could help defend the achieved developmental impact of their private equity programs.

Nevertheless, some MDFIs have made progress in this respect. In most cases, AfDB and IFC will not make a fund investment unless the fund manager is committed to reporting on developmental results such as job creation and the impact on technology. In contrast, the EBRD tends to be less stringent on developmental requirements. An EBRD representative noted that the bank does not require fund managers to report on development metrics. However, it does require that a fund’s investee companies adhere to certain social and environmental standards. The IFC has perhaps the strongest requirements in these areas. The IDB is planning to implement poverty alleviation impact assessment metrics for its private equity investment program.

CONCLUSION

Over the last decade, private equity fund investing has become increasingly popular among multilateral development finance institutions, providing some of their highest earnings. At many institutions, private equity fund operations continue to grow rapidly. This phenomenon will have an important impact on emerging markets. The African Development Bank has

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**EXHIBIT 7**

Performance of Private Equity Fund Programs

![Chart showing IRR (Net of Management Fees) for different institutions: IDB 16%, AfDB 15%, EBRD 13.2%, and ADB 6.9%. Sources: Interviews with MDFIs, ADB Evaluation of Private Equity Fund Operations, EBRD Presentation: Performance of Private Equity Funds in Central and Eastern Europe and the CIS 2006.**
added five to six new funds to its portfolio in the last six months. According to the AfDB’s director of private sector operations, private equity is now the bank’s “dominant vehicle for equity investment.” The Islamic Development Bank has plans to add a new multi-fund platform to substantially expand its private equity investments in its member countries. EIF, ADB, and MIF have pioneered “clean-tech” and clean energy initiatives as part of their private equity fund operations.

It is not clear whether these programs are making appropriate levels of contribution toward the MDFI’s development goals. This has proven exceedingly difficult to measure because development is a function of numerous variables, many of which are intangible. Moreover, fund management teams tend to be focused on returns, because this is how they are compensated. Perhaps the managers of these funds need an incentive structure based not only on financial performance but also on the MDFI’s development targets. If this were the case, the financial return expectation of private equity funds initiated by MDFIs would need to be adjusted to reflect overriding development objectives.

Whether this trend of MDFI investment into private equity continues in the face of the 2008 financial crisis remains to be seen. The crisis threatens to be the deepest and longest-lasting market retrenchment in 70 years. The flow of funds into all financial instruments has been deeply affected. Since equity investments (especially into the more vulnerable emerging countries) are the riskiest, they are generally the first to be reduced when market conditions deteriorate. Compared to investing in the shares of publicly traded companies, private equity investing is much more risky. Once a disbursement has been made, investors are committed to having their funds tied up for long periods of time (on the order of 10 years). This, coupled with the fact that fund investments can be difficult to accurately value, make them harder to justify. The public sector managers and boards of the MDFIs tend to be much more risk averse than typical institutional investors. It could well be that we have seen MDFI appetite for these investments peak. Only time will tell.

**Areas for Future Research**

*How does an MDFI’s involvement in a fund affect that fund’s performance?* The institutional requirements of an MDFI may take time away from investment professionals and restrict their ability to invest in certain classes of deals.

On the other hand, MDFI affiliation may increase deal flow and provide political risk cover such that MDFI affiliated funds outperform the general market.

*Are an MDFI’s social and environmental standards effectively passed down to investee companies through private equity funds?* One potential risk of investing in private equity funds is that MDFIs do not have a direct link to the special project companies that ultimately receive funding. Thus, they do not have direct oversight of whether or not social and environmental safeguards are enforced according to their policies.

*What should MDFI policies be with respect to supporting new fund managers?* Are MDFIs sacrificing opportunities to help new fund managers in order to gain higher returns from those who were successful in the past? Does an already successful fund manager really need the support of an MDFI? Should MDFIs support new fund managers or are they better off sticking with those who already know how to invest their money well?

*How can MDFIs best measure the success of their private equity fund operations?* Should fund performance be assessed on multi-dimensional metrics including developmental as well as conventional IRR metrics? Is it possible to translate the rationales noted in Exhibit 4 into measurable metrics so that multilaterals can track their nonfinancial performance objectives more closely?

**APPENDIX**

**INTERVIEW PROTOCOL**

1. **Background and History of the Multilateral Development Finance Institution**
   - Why does the MDFI invest in private equity funds? What is the development impact?
   - When did the MDFI begin its private equity fund operations?
   - How many times will the MDFI work with a given fund manager?
   - Are there any organizations that regularly cofinance funds with the MDFI?
   - How have the private equity fund operations of the MDFI evolved over time?

2. **Current Private Equity Fund Investment Operations**
   - How much of the MDFI’s capital is currently invested in private equity funds? What percentage of private sector investment is this? How many funds has this capital been committed to?
What percentage of a fund does the MDFI typically take?

What is the realized IRR to date of the MDFI’s private equity fund investments? What is the estimated total (realized and unrealized) IRR to date of these investments? Why has the portfolio performed in this way?

How are the MDFIs’ current private equity fund investments distributed? How many venture capital funds? How many buyout funds? How many infrastructure funds? Is there a subregional/national focus? Are there any other special areas of focus?

Does the MDFI initiate its own funds? If so, how many funds has the MDFI initiated?

What role does the MDFI typically play in the management of funds in which it invests?

What department or division currently oversees the private equity fund investments of the MDFI? How is that division structured? How many investment professionals work in this division? What are the backgrounds of the investment professionals? What other responsibilities does this department have?

Does the MDFI have any plans to change its private equity fund operations in the future? If so, how? Are there any plans to change the level of capital? Are there any plans to change the management structure?

ENDNOTES

1This value is calculated from the individual total commitments of ADB, AfDB, EBRD, EIF, IDB, IIC, IFC, and MIF. The total commitments of each MDFI are listed in Exhibit 1.


3These numbers were provided in interviews with representatives of the MDFIs.

4See http://www.adb.org/ PrivateSector/fund-operations/default.asp

5See http://www.eif.org/about/index.htm


The primary and secondary rationales are based upon general information from websites, annual reports, and interviews, as well as analysis and interpretation by the authors. For example, the Multilateral Investment Fund invests only in VC funds and discussed its significant emphasis on SMEs on its website and during the interview. For this reason, we coded their primary rationale as promoting SMEs, innovation, and entrepreneurship. In completing the coding, we had a relatively high degree of confidence in coding the primary rationales, but identifying secondary rationales involved considerably more interpretation and may be more debatable.

Robert Bestani (former Director General Private Sector Finance, Asian Development Bank) has argued convincingly that the main value proposition of the multilaterals is no longer supply of capital, which is a role where they have no inherent competitive advantage over other commercial banks. He observes that the comparative advantage of the MDFIs lies in protecting against government intervention, which makes them more akin to (political) insurance companies. Private sector investors have long recognized the benefits of multilateral involvement in managing political risks, but the ADB appears to be the first institution to have internalized this feedback from the market. It has adopted political risk mitigation as part of its core strategy and offers private investors formal channels of dialogue and influence at high levels within host governments. See Bestani, R. “Infrastructure’s Unbalanced Equation.” Euromoney Yearbooks, 2008. Available at: http://www.adb.org/pnsd/default.asp.

Interestingly, the World Bank made a conscious decision roughly 12 years ago to exit the infrastructure sector and is now urgently trying to increase its infrastructure focus.


9See http://www.eif.org/venture/activity/index.htm

10Under current market conditions, carry typically amounts to 20% of fund returns after LPs earn a preferred return of 8%. Conventional wisdom suggests that carry aligns the interests of private equity management with that of the investors.

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