ADB

Report and Recommendation of the President to the Board of Directors

Project Number: 40901
April 2006

Proposed Equity Investment
Blue River Capital I

In accordance with ADB's public communications policy (PCP, 2005), this abbreviated version of the RRP excludes confidential information and ADB's assessment of project or transaction risk as well as other information referred to in paragraph 126 of the PCP.

Asian Development Bank

ABBREVIATIONS

ADB	–	Asian Development Bank
BPO	–	business process outsourcing
DMC	–	developing member country
FDA	–	Food and Drug Administration
FI	–	financial intermediary
GDP	–	gross domestic product
IPO	–	initial public offering
IRR	–	internal rate of return
IT	–	information technology
NAV	–	net asset value
OED	–	Operations Evaluation Department, ADB
OEM	–	original equipment manufacturer
PIPE	–	private investment in public enterprise
PRC	–	People's Republic of China
PSOD	–	Private Sector Operations Department, ADB
R&D	–	research & development
RMU	–	Risk Management Unit, ADB
ROI	–	return on investment
SARD	–	South Asia Department, ADB
SME	–	small or medium-sized enterprise
WTO	–	World Trade Organization

NOTE

In this report, "$" refers to US dollars.

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Director General	R. Bestani, Private Sector Operations Department (PSOD)
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I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed equity investment in Blue River Capital I, L.L.C. (the Fund) of up to $25 million or 25% of the Fund's total share capital, whichever is less.

II. RATIONALE: BACKGROUND, CHALLENGES, AND OPPORTUNITIES

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2. There are significant opportunities for well positioned companies and investment funds operating in India today. The economic expansion of the last decade has resulted in an increasingly large, employed, and consumption-oriented class of young people in India, leading to significant increases in domestic demand across many industries. India's attractiveness as an outsourcing and offshore location is creating a burgeoning export market for both services and manufacturing. There are opportunities for both domestically focused companies (in such areas as retail, infrastructure, health care, and media and entertainment) and export-oriented businesses (in such areas as automotive components, specialty chemicals, textiles and clothing, pharmaceuticals, information technology services, and business process outsourcing).

A. Background

3. **Large Domestic Market.** The Indian economy has grown at a consistent annual rate of approximately 6% over the last decade as it has liberalized and embraced an open, capitalist economic model with increasingly globalized businesses. The GDP per capita is now $2,900. The country's approximately 1.2 billion population creates a significant demand for products and services, affording Indian producers the opportunity to grow rapidly. In addition, about 54% of the Indian population is under the age of 25; the trend among these younger Indians is to earn and spend more than did previous generations, thanks in part to the availability of consumer credit.[1] India's manufacturing and service sectors is growing rapidly to meet this burgeoning domestic demand, creating significant investment opportunities.

4. **Large Export, Outsourcing, and Offshore Market.** India's first real taste of success in global markets occurred in the late 1990s with the growth of the information technology (IT) industry. Today, the IT industry contributes approximately $14 billion to India's GDP, employs almost 5.25 million people, and represents $50 billion in aggregate market capitalization, virtually none of which existed 15 years ago. The success of the IT industry was followed by growth of business process outsourcing (BPO). India has rapidly developed into a de facto hub

[1] These increases in spending and growth are evident in data as mobile phone penetration, which has increased by two million subscribers per month for the past year, and is anticipated to grow from 50.8 million subscribers in early 2005 to 175 million by 2008. Likewise, automobile purchases increased substantially from 550,000 cars in 2003 to 675,000 cars in 2004. Increased availability of home mortgage financing and legal reforms has made home ownership more affordable and achievable to the burgeoning Indian middle class. These data all underscore the current flourishing of the Indian domestic market.

for back office services, employing close to 2.5 million people, performing such functions as call center operations and transaction processing services. The growth of the IT and BPO industries has been enabled by India's vast, educated, English-speaking population. India's exports of IT and BPO services grew at an annual rate of more than 50% from 1992 through 2004 and are projected to increase from $13 billion in 2003 to $60 billion in 2010.[2]

5. In addition to services, several other sectors have also shown promise over the past few years, driven by (i) India's large supply of skilled labor, (ii) a global shortage of skilled labor in the medium to long term, (iii) proximity to India's vast natural resources, and (iv) macroeconomic reforms and trade liberalization. Sectors that have demonstrated or started to demonstrate global success include generic pharmaceuticals, automotive components, specialty chemicals, and textiles and clothing. McKinsey & Co anticipates that India will emerge as the second destination for manufacturing after the People's Republic of China (PRC), and that by 2015 India could be exporting $300 billion of goods (increased from $48 billion in 2003).[3]

B. Opportunities

6. There are opportunities in export-oriented companies and in domestically-focused businesses.

7. **Automotive Components.** The global automotive components industry is a $1.1 trillion market and is expected to grow to $1.7 trillion by 2015. India's automotive components industry is a $5 billion market. Of this, $1 billion is exported and exports are projected to grow to $4 billion by 2010 (footnote 2).[4] The compound annual growth rate for the Indian industry has been 23% for the last 5 years. The competitive advantage of Indian automotive component manufacturers derives from their low labor costs,[5] high quality,[6] design and engineering capability,[7] software and hardware synergies,[8] and growing local and export markets.[9] The automotive components industry is characterized by strong demand, a pronounced need for capital,[10] and the promise of consolidation[11] with robust opportunities for strong companies.

[2] NASSCOM and McKinsey & Company. 2005. *The NASSCOM-McKinsey Study 2005.* "Extending India's Leadership of the Global IT and BPO Industries." Available: http://www.mckinsey.com/ideas/articles/Nasscom_3_Executive_summary.pdf

[3] CII and McKinsey & Company. 2004. *Made in India: The Next Big Manufacturing Export Story.* New Delhi: CII & McKinsey.

[4] Increasingly, automotive components are sourced from developing countries instead of the developed world. The United States, for example, ran a $19 billion trade deficit in automotive components in 2002 (compared with a $4 billion trade deficit in 1997).

[5] Average wage rates of $8 per hour versus $20 per hour in developed markets.

[6] About 80% of manufacturers have a quality or process certification (ISO/QS/TS/Deming). As the Indian market has moved away from protectionism toward an open economy, these manufacturers had to improve quality and productivity in order to compete with global players.

[7] Almost 294,000 engineers graduate from college every year, providing an impressive depth of talent. As the complexity of automotive components and accessories increases, there is a shift away from sourcing arrangements with few suppliers toward a model of broader relationships with niche, product-specific suppliers, a trend that should benefit India.

[8] India's expertise in software and hardware integration extends into optimizing manufacturing processes and automation, reducing overall manufacturing costs.

[9] Several global auto manufacturers are targeting the Indian market for growth and in doing so, are increasingly manufacturing and assembling cars in India. Supplying automotive components to domestic and export markets makes for a more sustainable industry. BMW, Ford, Hyundai and Toyota are already taking advantage of this trend.

[10] It is estimated that approximately $500 million per annum of fixed asset capital expenditure is needed in India to match growth forecasts, and that about 25-30% of that will have to come from equity capital infusions. Automotive component manufacturers need to increase capacity, invest in technology, R&D and logistics management.

8. **Specialty Chemicals.** The specialty chemicals industry is estimated to be a $375 billion global market. India's specialty chemicals industry is a $7 billion market, of which $0.5 billion is exported. Over the next 5 years, the industry is projected to more than double to $18 billion, with exports growing from $0.5 billion to $2.0 billion. The industry is well-suited to benefit from India's technical and process expertise; there is a large talent pool of low-cost engineers and chemists and Indian companies have begun to employ a high degree of innovation, primarily in the establishment and design of fixed asset and manufacturing facilities to create cost advantages. Domestic growth rates are also attractive, enabling companies to have a healthy balance of export and domestic exposure.

9. **Textiles and Clothing.** The global clothing trade was worth $240 billion in 2003 and is expected to reconfigure significantly as a consequence of the dismantling of the Multi Fiber Arrangement in January 2005. Annual clothing exports from India are currently about $6 billion and have the potential to grow to between $25 billion and $30 billion by 2015. The increasing dominance of mass market retailers in the United States (such as Wal-Mart and Target) has led to declines in clothing prices and increasing pressure on US retailers to import. Factors that make India attractive as a sourcing hub in the basic[12] and the value-added segment[13] include the fact that companies are looking for an alternative destination to the PRC;[14] India's design skills[15] and raw materials;[16] and emerging clusters in India's clothing sector.[17]

10. **Pharmaceuticals.** In developed overseas markets such as the US and UK, macroeconomic trends—particularly the rising costs of every part of the healthcare industry—are putting huge pressures on the health care system.[18] These cost increases are increasingly leading companies to seek lower-cost alternatives and moving R&D, manufacturing, drug discovery, and medical services offshore has increased dramatically. India's healthcare exports are growing rapidly, and are expected to reach $12 billion by 2015 (from $410 million in 2005).[19] Growth in pharmaceuticals exports in particular will be driven by (i) India's well-educated scientists and engineers; (ii) the fact that the US Food and Drug Administration (FDA) is

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[11] The Indian market is highly fragmented with more than 400 automotive component manufacturers. The top 10 have a market share of 7%. In addition, there are only 50 companies with revenues more than $30 million.

[12] This represents 70–75% of world trade in clothing and includes men's shirts, trousers, suits and coats, women's skirts, trousers, tops, and innerwear.

[13] This represents 25–30% of world trade in clothing and includes dresses, coats, and accessories such as ties.

[14] The PRC seems positioned to capture almost 50% of the clothing trade, with India being the second destination of choice, with the potential to capture 15% of global market share.

[15] Indian companies are extending the definition of sourcing to include design. Several companies assign designers that work from their clients' offices in the target markets, coordinating continuously with production sites on such matters as new fashion trends and changes in design.

[16] India is the world's third largest producer of cotton, the second largest exporter of cotton yarn, and, among emerging countries, the fourth largest exporter of synthetic fabric. This enables it to build an efficient and integrated supply chain for garment production.

[17] With the government establishing tax incentives for capital expenditures and migration of the industry from a cottage industry, garment-manufacturing clusters have emerged and new clothing parks have been proposed, with future consolidation anticipated. Government policy has become very supportive, removing many of the barriers to industrialization of the sector and will continue to play a key role.

[18] These include rapidly rising medical costs, increases in drug prices, and poor hospital cost containment; rising cost of medical innovation (the cost of new drug development is now more than $800 million per drug), high cost of medical device development; patent expiration (more than $15 billion exposure to patent expiry by 2010); and gaps in the drug discovery pipeline.

[19] According to HSBC Global Research, the global outsourcing and offshore potential of all healthcare services could reach about $220 billion, with annual growth of 8–10%. HSBC forecasts that India, conservatively, should be able to claim $12 billion annually by 2015. HSBC Global Research. 2005. *Healthcare - India: Just What the Doctor Outsourced.* India.

approving more facilities outside the US; and (iii) the fact that India's pharmaceutical industry is increasingly conforming to WTO patent standards. Perhaps the most pronounced competitive advantage is cost; in India, overall research and development costs are about 12%, manufacturing costs are 20-40%, and overall clinical development costs are 40-50% of costs in developed countries.

11. **IT Services.** Over the past 10 years, India has emerged as the country of choice for companies looking to outsource IT services. It is estimated that IT exports increased from $15 million in 1988 to $10 billion in 2003. On the back of continued efforts by multinational companies to lower IT costs and technological advances that allow large, long-term projects to be executed from remote locations, it is likely that India's IT exports will reach $25 billion by 2008. With the second largest English-speaking IT-trained population in the world, world-class software technology parks and relationships with more than 60% of the Fortune 500 companies, IT outsourcing to India is now not only accepted but expected. Nevertheless, India's penetration of the global IT market is only 2%, implying tremendous potential for growth.

12. **Specialized Business Process Outsourcing (BPO).** Advances in telecommunications mean that India has recently become a preferred destination for call centers and other BPO activities. The first wave of BPO consisted of simple inbound and outbound calling. However, with the establishment of large "captive" centers by companies such as Dell, GE, and American Express, there are investment opportunities in specialized BPO services focused on particular industries such as healthcare, insurance, consumer finance, and retail, or on niche functions that require skilled labor and process management.

13. **Infrastructure.** The Government's focus on developing infrastructure in India has provided an impetus to the private sector. In addition to $38 billion of government spending as part of a 5-year plan through 2007, private sector infrastructure investments of at least $125 billion are anticipated. Industries that feed into the construction of infrastructure, such as floating-glass, pipeline, and electrical components manufacturing, are growing and new types of business are emerging, such as engineering services, payment processors, logistics management, information services, vocational training, and others.

14. **Media and Entertainment.** India is the world's third largest TV viewing nation (88 million TV homes and 44 million cable and satellite homes) but generates less than 1% of global revenue. With the new commitment of the Telecom Regulatory Authority of India to introduce competition in cable and satellite distribution, the business environment for the media sector is anticipated to improve. Television advertising spending is projected to grow by over 13% per year over the next 3 years and to reach $1.3 billion by 2007. This would give television a 40% share of total advertising spending. With broadcasting regulations becoming more favorable, investment opportunities will arise in broadcasting, content, film distribution, and animation.

C. Challenges

15. **Weaknesses in Target Industries.** The previous section described the opportunities that exist in the Fund's target markets. However, these emerging industries also suffer from many weaknesses associated with immature or not-yet-established markets.

(i) **Pharmaceuticals.** Although India has a highly developed skill base in pharmaceutical manufacturing and process chemistry, the industry is extremely fragmented, with over 50,000 companies engaged in some form of pharmaceuticals manufacturing.[20] Compliance with international standards is underdeveloped, and India lacks the capacity to undertake the entire R&D cycle through to the introduction to the market. In other words, India is not yet able to compete globally in the pharmaceutical industry and no Indian pharmaceutical manufacturer is included in the world's top 10 firms.[21]

(ii) **IT services.** The opportunity for India in IT services is well understood and well established. There is a huge worldwide market and India has a highly skilled workforce. However, in IT services (estimated to be an $18 billion market), only 11 or 12 companies have annual revenues of over $300 million, and only 20-25 have annual revenues over $100 million. Although the country has IT talent and technical skills, Indian managers lack experience in operating large IT services companies, and of migrating from the $50 million range to the $500 million range.[22]

(iii) **Automotive components.** The automotive components industry is well established in India and there is significant expertise in castings and forgings, a technical and process-oriented workforce, and an outsourcing model that has gained traction with major global original equipment manufacturers (OEMs) in recent years. However, the market is highly fragmented, with about 550 players, of which about 15 have sales of over $150 million a year, and another 50 have sales of between $25 million and $150 million a year.[23]

16. **Lack of Available Financing.** Despite the emergence of promising companies targeting both export and domestic markets, there are few financing options available. The challenges of accessing capital for growth and expansion capital for middle-market firms are significant.

(i) **Public equity markets.** Although India's stock market has over 5,000 listed companies, a public listing is by no means a guarantee of liquidity. Stock market illiquidity is a serious, and growing, concern.[24] According to the Bombay Stock Exchange, the top 100 companies alone account for about 99% of trading volume.[25] The *Hindu Business Line* notes that more than half of listed companies are not traded at all, and notes that trading is active only for the top 100.[26]

(ii) **Public debt markets**. Corporate debt is an underdeveloped asset class in many emerging markets. In India, for example, it represents only 1% of the country's

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[20] The top players have only a 5% market share in the Indian market, and the top 20 in aggregate represent only 20% of the market. Some players focus on just one city or just one drug.

[21] Discussions with Pakhi Jain, a pharmaceuticals analyst for Edelweiss Capital, Bombay, December 2005. Edelweiss Capital is a leading Indian middle-market investment bank with a full equity research arm.

[22] Based on industry analysis provided by Edelweiss Capital, Bombay, December 2005.

[23] Discussions with Harish Sharma, an automotive components analyst for Edelweiss Capital, Bombay, December 2005.

[24] Numerous factors have contributed to the present state of illiquidity in Indian stock markets, including low capital base of listed companies (there are about 2,000 listed companies with a paid-up capital of $30 million and below); progressive reduction in public offerings from 60% of the issued capital to 25/10% for eligibility for listing (i.e. companies can list on a stock exchange only when at least 25% of each class or kind of securities is offered to the public for subscription, and if their issued and subscribed equity capital after the public issue is 10 crores rupees (or approximately $2.22 million)); switch-over to proportionate allotment of securities; free pricing of shares; introduction of book-building in respect of IPOs; and introduction of an order-driven system and of rolling settlement. "Regional Stock Exchanges", p. 94. http://www.bseindia.com/downloads/RegionalStockExchanges.pdf

[25] "Regional Stock Exchanges", p. 94. Available: http://www.bseindia.com/downloads/RegionalStockExchanges.pdf These figures stand in sharp contrast to, for example, the NYSE, on which no single company represents more than 1% of daily turnover.

[26] Stock market: Barometer of economy? Available at: http://www.blonnet.com/2005/03/24/stories/2005032400830800.htm

financial assets, and is not an option for many small and medium-sized enterprises.[27]

(iii) **Cash-flow bank lending**. Both foreign and local banks provide cash-flow lending, but this is essentially limited to loans for working capital requirements (i.e., short-term loans of several weeks to several months) and precludes longer tenor funding to support capital expansion growth.[28]

(iv) **Longer-term bank lending**. While some banks may be willing to lend for longer terms, they typically prefer more mature companies; small companies face high costs of bank borrowing and often unacceptable conditions.[29] Banks often rely on lending methods that are not viable for fast-growing companies that require immediate commencement of loan payments.[30]

(v) **Asset-based financing**. Banks offer asset-based financing, but this is inappropriate for many companies. Services companies may not have enough assets to pledge as collateral in order to qualify for long-term lending. Indian banks are also quite strict in terms of the amount of leverage they will provide, and will typically not exceed a debt:equity ratio of 1:1.[31] Hence, even companies that are not asset-constrained will bump up against ceilings for bank lending very quickly, since bank loans will be unavailable in the absence of equity.

17. Given the constraints listed above, private equity becomes not only an attractive option for many companies, but also in many cases the *only* viable option. In the absence of private equity funding, middle-market companies rely on retained earnings to finance expansion, and are unable to grow beyond a certain pace and size.

18. **Shallow Private Equity Middle Market in India.** In recent years India's private equity market has trended toward stage-specific rather than broad-based funds. With smaller, early-stage venture capital deals and larger, later-stage transactions ($20 million to $50 million) absorbing much of the market's attention and financing for private equity, middle-market companies have been left underserved and undercapitalized. While there are more than 1,000 middle-market companies in India, few funds focus on investing in this segment..

III. THE PROPOSED FUND

A. Objectives and Description

[CONFIDENTIAL INFORMATION HAS BEEN DELETED]

19. The primary objective of the Fund will be to achieve significant long-term capital appreciation through equity and equity-related investments in Indian middle-market companies.

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[27] Chawla, Anil. 2005. Leverage Financing in India. GE Capital presentation at the 2005 Asian Venture Forum – India, slide 2.
Available: http://www.asianfn.com/conferences/presentations/2005_AVF_India/GE%20India_Anil%20Chawla.pdf

[28] Based on conversations with ADB's India Resident Mission and South Asia Department.

[29] For example, personal guarantees and excessive collateral.

[30] In the pharmaceuticals industry, for example, investments in plants and machinery often precede cash returns from investments by several years. Bank loan officers, however, often require interest and principal to be repaid starting immediately following the loan.

[31] This was a point raised repeatedly during due diligence with funds in India. In certain cases, banks may be willing to go as high as 1.5:1 or 2:1, but this is the extreme upper limit and is rare.

B. Fund Management

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20. **Fund and Fund Manager.** The Fund Manager's primary responsibilities are to manage the operations of the Fund, implement the Fund's investment program, and make final investment recommendations to the board of the Fund. The Fund Manager will enter into an investment advisory agreement with Blue River Capital Advisors (India) Private Limited (the Investment Advisor). Senior members of the Investment Advisor will form an investment committee (the Investment Committee), which will undertake an evaluation of investment opportunities and provide non-binding investment advice to the Fund Manager. The Fund will have an office in Mumbai, India, and will be managed by a local team of 8-10 professionals.

21. **Edelweiss Capital.** The Fund was founded by one of its managing directors, and by Edelweiss Capital Limited, one of the leading investment banks in India. Edelweiss Capital started in 1996 as an advisory firm helping companies raise capital from the venture capital and private equity industries, and over the years has expanded into a full-fledged investment bank.

C. Governance Structure

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22. The Fund Manager will manage the operations and make all investment decisions on behalf of the Fund.

23. The Fund Manager will enter into an investment advisory agreement with the Investment Advisor. The Investment Advisor will advise the Fund Manager on investment opportunities for the Fund and the disposition of the Fund's investments and provide services with respect to the Fund, including investigating and structuring potential investments and exit opportunities, and monitoring the performance of the Fund's portfolio companies. All services of the Investment Advisor relating to the Fund will be subject to review and final approval by the Fund Manager.

IV. INVESTMENT BENEFITS, IMPACTS, AND RISKS

A. Justification

1. Development Impact

24. By investing in the Fund, ADB intends to achieve the following developmental objectives.

(i) Private sector development will be stimulated, creating jobs and contributing to an employed, and therefore increasingly stable, middle class. This will contribute to the country's long-term economic progress and overall stability.
(ii) Equity will be provided to address shortages of risk capital for small and medium-sized companies that constrain their growth. Long-term capital in the form of private equity from private sources will be mobilized for entrepreneurial companies to finance regional expansion and productivity increases.
(iii) Sustainable employment will be created in the companies the Fund invests in.
(iv) Sources of finance available for entrepreneurial companies will be increased by the addition of equity finance, which will enable these companies to buy fixed

assets and use them as collateral for commercial bank loans to leverage their expansion. This process will help medium-sized companies to graduate to larger enterprises and eventually to raise capital by listing on the stock exchange.

(v) The Fund will demonstrate to the private sector that investment in entrepreneurial companies in India can be commercially attractive, thus catalyzing investments by building up local private equity investment management capacity.

(vi) This demonstration effect will be achieved through domestic private equity teams, which will develop a body of experienced finance professionals and provide support to a first-time fund manager.

(vii) Management advice will be provided to entrepreneurial companies on financial planning, business expansion strategies, human resource development, and implementation of international standards of corporate governance. This will support the rationalization of highly fragmented industries, thus supporting progress toward India's goal of developing industries capable of competing on a global basis.

(viii) The Fund's investments will contribute to the development of the regulatory and legal environment in India. The Fund manager will report regularly on regulatory issues encountered by portfolio companies. This information will be reported regularly to ADB's SARD, thus facilitating productive discussion with the Indian government vis-à-vis overcoming key regulatory constraints and encouraging a regulatory framework supportive to entrepreneurship.

2. Value Added by ADB

25. ADB's investment in the Fund will add value in the following ways.

(i) **Catalytic and demonstration effect.** Given the significant risks facing potential investors, and the emerging nature of the Indian private equity industry, ADB will play a catalytic role in attracting additional local and foreign long-term private investments to India. ADB's intervention will demonstrate the credibility of private equity in India and mobilize capital to support other private equity funds.

(ii) **Private sector development.** The Fund, like others in which PSOD invests, will make a direct contribution to private sector development. The Fund will employ market-based mechanisms to develop profitable and sustainable enterprises. Its focus on emerging sectors at very early stages of consolidation will provide capital, management skills, and corporate governance oversight to assist in the rationalization and development of these highly fragmented industries. ADB's contribution will help India to implement its private sector development strategy.

(iii) **Value added by Fund Manager.** ADB involvement in the Fund will support the Fund Manager's efforts to create a Fund that will improve portfolio companies' management systems and corporate governance.

B. Measuring Development Effectiveness

26. The ADB PSOD and Operations Evaluation Department (OED) are formulating guidelines for implementing good practice standards for evaluation of private sector investment operations, which were prepared by the Evaluation Cooperation Group[32] of the multilateral

[32] The Evaluation Cooperation Group was formed by the multilateral development banks to design common evaluation standards for private sector operations. The group's work is ongoing and some aspects of the present evaluation framework might change to correspond to best practices.

development banks. The good practice standards cover the roles of the independent evaluation department and the private sector department, the evaluation dimensions for private sector operations, the nature of annual reporting, and dissemination of reports and lessons. According to the good practice standards, the three principal dimensions for private sector evaluation are development outcome, investment profitability for the institution, and operational effectiveness. PSOD will measure the expected development outcome of the Fund by monitoring particular performance measures throughout the life of the Fund. The performance measures are grouped into three key areas.

(i) **Business performance**. These performance measures gauge the extent to which the Fund has reached its objectives in terms of the overall profitability and commercial viability of the Fund and its investee companies.

(ii) **Economic sustainability**. These performance measures assess the effect of the Fund on the economy, and associated benefits and costs. These measures evaluate the extent to which the Fund improved the allocation of resources and provision of financial services to viable private enterprises. They also evaluate whether the investee companies generated direct positive effects on the local economy.

(iii) **Private sector development**. These performance measures evaluate the indirect impact of the Fund on private sector development, e.g., its contribution to the growth of viable financial institutions and the development of financial markets.

27. Quantitative and qualitative measures of performance are summarized in Appendix 1.

C. Environmental Protection and Social Safeguard Policies

28. The Fund is classified as category FI (financial intermediary) and no significant environmental impact is anticipated. The impact on resettlement and indigenous peoples has been classified as C (no impact). All companies in which the Fund invests will be required to comply with national environmental laws, regulations, and standards, as well as ADB's environment and social safeguard policies.

29. The implementation of an environmental management system, which includes ADB's environmental and social safeguards, adds value to the Fund. Close coordination with ADB will be necessary to ensure that the fund manager possesses the skills to screen and categorize prospective investments on the basis of environmental and social impact. The Fund will ensure that at least one of its employees has received training in applying ADB's social safeguard policies. The Fund Manager will appoint a senior officer to implement and supervise the environmental and social management system, and an environmental coordinator to review compliance with all applicable ADB policies by companies the Fund invests in. The Fund will develop an environmental management system that is satisfactory to ADB and in accordance with the guidelines set out in Appendix 5, and is committed to its implementation.

D. Anticorruption Policy; Combating Money Laundering and the Financing of Terrorism

30. The Fund has been advised of ADB's anticorruption policy[33] and its policy relating to the combating of money laundering and the financing of terrorism.[34] Consistent with its commitment to good governance, accountability, and transparency, ADB will require the Fund Manager to institute, maintain, and comply with internal procedures and controls that follow international best practice for preventing corruption or money laundering or the financing of terrorism. The Fund Manager will covenant with ADB to refrain from engaging in such activities. The investment documentation between ADB and the Fund will allow ADB to investigate any violation or potential violation of these undertakings. The Fund Manager already has in place an extensive framework for training employees to prevent money laundering, and is well positioned to comply with ADB's requirements.

V. ASSURANCES

31. ADB will enter into suitable documentation that will indicate ADB's commitment to invest an amount up to the lesser of $25,000,000 or 25% of the Fund's total share capital (including parallel investment vehicles, if any) following approval of the investment by ADB's Board of Directors. ADB will not be largest investor in the Fund. ADB will satisfy itself with the terms and conditions of the all principal documents associated with its investment of the Fund, including the investment management agreement between the Fund and the Fund Manager.

VI. RECOMMENDATION

32. I am satisfied that the proposed investment in Blue River Capital I, L.L.C. as described in this report complies with the Articles of Agreement of ADB and recommend that the Board approve the investment of up to the lesser of $25,000,000 or 25% of the Fund's total share capital in Blue River Capital I, L.L.C. from ADB's ordinary capital resources.

Haruhiko Kuroda
President

26 April 2006

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[33] ADB. 1998. *Anticorruption.* Manila.
[34] ADB. 2003. *Manual on Countering Money Laundering and the Financing of Terrorism*. Manila.

PERFORMANCE MEASURES FOR DEVELOPMENT OUTCOMES

Concept	Impact	Performance Measures (Qualitative and/or Quantitative)
Business Performance (Fund)		
• Financial objectives	• Overall profitability of the Fund	• Gross internal rate of return (database)[a] • Net internal rate of return (database)
Economic Sustainability (Fund and Subprojects)		
• Efficient allocation of finance and/or provision of financial services to economically viable enterprises	• Subproject economic performance	• Annual net profit of subproject (database) • Annual net revenue of subproject (database)
	• Stronger local entrepreneurship	• Number of entrepreneurial projects receiving finance from the Fund (database) • Number of returning entrepreneurs and skilled workers from industrialized countries receiving finance and transferring skills (database)
	• Contribution to widening the access to finance of SMEs	• Additional debt raised by subprojects as a result of the equity investments (database)
	• Provision of value-added services, enhancing the viability of SMEs	• Number of enterprises advised (database) • Quality of advice in financial planning, expansion strategies, human resource development, accounting standards, corporate governance and management training (PCR)
• Additional direct contributions of subprojects to the local economy	• Contribution to government revenues	• Increased amount of taxes paid by subprojects (database)
	• Employment generated	• Number of jobs created by subprojects (database) • Quality of jobs created by subprojects e.g. technical jobs (PCR)
	• Adoption of new technologies and production processes	• Increased investment in new technologies and/or in improvement of production processes by subprojects (PCR) • Number of subprojects implementing successful new technology (PCR) • Increased quality and/or lower price of subproject's product due to investment in technology (PCR)

Concept	Impact	Performance Measures (Qualitative and/or Quantitative)
Private Sector Development (Impact Beyond Fund and Subprojects)		
• Contribution to the growth of viable financial institutions and financial market development	• Positive impact on regional integration	• Number of companies enabled to expand regionally through the Fund's provision of equity capital • Number of companies enabled to expand regionally through the Fund's support in upgrading management systems
	• New technology, development of management skills, and employee training in domestic financial sector	• Number of local investment professionals in SME private equity trained by the Fund (PCR) • Number of Fund's investment professionals raising a subsequent fund in financial sector of a DMC (PCR)
	• Resource mobilization through private equity	• Mobilized domestic finance for investments in productive SMEs by the Fund (at closing of the Fund) • Mobilized international finance for investments in productive SMEs by the Fund (at closing of the Fund)
	• Growth in financial services in the domestic financial markets[b]	• Growth in private equity market in the domestic financial sector (PCR) • Increased access to long-term finance (PCR)

ADB = Asian Development Bank, DMC = developing member country, IRR = internal rate of return, PCR = project completion report, SMEs = small and medium-sized enterprises.

[a] Performance measures followed by "(database)" will be monitored regularly in the framework of the private sector operations department's database for funds. Performance

[b] Growth in financial services in the domestic market will be measured at the level of the whole economy, not at the level of the Fund.

Source: Asian Development Bank, Private Sector Operations Department.