



# Report and Recommendation of the President to the Board of Directors

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Project Number: 40926  
June 2006

## Proposed Equity Investment in Kula Fund II Limited

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                               |
| Aureos | – Aureos Capital Limited                               |
| AusAID | – Australian Agency for International Development      |
| CDC    | – Commonwealth Development Capital                     |
| DMC    | – developing member country                            |
| GDP    | – gross domestic product                               |
| GPS    | – good practice standard                               |
| IRR    | – internal rate of return                              |
| NZAID  | – New Zealand's International Aid & Development Agency |
| PCR    | – project completion report                            |
| PSOD   | – Private Sector Operations Department                 |
| PNG    | – Papua New Guinea                                     |
| SME    | – small and medium-sized enterprise                    |
| TA     | – technical assistance                                 |

## NOTE

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

|                          |   |
|--------------------------|---|
| <b>Vice President</b>    | L. Jin, Operations Group 1                              |
| <b>Director General</b>  | R. Bestani, Private Sector Operations Department (PSOD) |
| <b>Officer-in-Charge</b> | W. Willms, Private Sector Operations Division, PSOD     |
| <b>Team leader</b>       | V. John, Principal Structured Finance Specialist, PSOD  |
| <b>Team member</b>       | D. Wiedmer, Structured Finance Specialist, PSOD         |

## CONTENTS

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|  | <b>Page</b> |
|--|-------------|
| I. PROPOSAL                                      | 1           |
| II. INVESTMENT RATIONALE AND DEVELOPMENT IMPACT  | 1           |
| A. Background                                    | 1           |
| B. Challenges and Opportunities                  | 2           |
| C. Development Impact                            | 3           |
| D. Measuring Development Effectiveness           | 4           |
| III. THE FUND                                    | 5           |
| A. Fund Objectives                               | 5           |
| B. Fund Management                               | 5           |
| IV. ASSURANCES                                   | 7           |
| V. RECOMMENDATION                                | 7           |
| <br>   |             |
| APPENDIX   |             |
| 1. Performance Measures for Development Outcomes | 8           |



## I. PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed equity investment in Kula Fund II Limited (the Fund) of up to \$5 million or 25% of the Fund's total share capital, whichever is less. The Asian Development Bank (ADB) shall not be the single largest investor in the Fund.

## II. INVESTMENT RATIONALE AND DEVELOPMENT IMPACT [CONFIDENTIAL INFORMATION HAS BEEN DELETED]

### A. Background

#### 1. More Steady Economic Growth

2. Over the past 5 years, Pacific island economies have improved after times of severe political instability in Papua New Guinea (PNG), Fiji Islands, and Solomon Islands; and the global economic downturn in 2002–2003. Real gross domestic product (GDP) growth in the region averaged 2.1% over 1999–2003, notwithstanding prolonged contractions in the economies of PNG, Solomon Islands, and Vanuatu. Consumer price inflation was also kept in check between 1999 and 2003, averaging 4.6%, even though inflation in some economies remained or accelerated into double digits.

3. The combination of moderate inflation and steady growth is attributable to various factors, including the following.

- (i) Normalization of political and economic activity following the coup d'état in the Fiji Islands, and rapid reconstruction following the collapse of political institutions and the economy in the Solomon Islands. However, recent riots in the Solomon Islands show the continuing vulnerability.
- (ii) Improving economic and political conditions in PNG following the enhanced engagement of multilateral development institutions and the Government of Australia.
- (iii) Gradual improvements in fiscal discipline in some countries and an increased focus on the quality of public expenditure and rationalization of the public sector in those countries.
- (iv) Robust recovery in world commodity and cash crop prices, boosting export revenues for minerals, timber, palm oil, copra, cocoa, vanilla, and squash.

4. Although the investment climate in the Pacific islands will remain challenging for the foreseeable future, gradual improvements in the economic and political landscape of many countries in the region is expected to create opportunities for investors. In the two largest economies, PNG and Fiji Islands, economic growth will be underpinned by strong foreign direct investment inflows in the mining, energy, and tourism sectors. Growth prospects in the smaller economies will largely depend on agricultural performance and the development of niche subsectors, such as organic farming and ecotourism, in addition to more general tourism.

#### 2. Shortage of Risk Capital for Small and Medium-Sized Enterprises (SMEs)

5. In order to exploit the opportunities generated by these broadly stable economic conditions, many SMEs in the Pacific islands require medium-to-long-term capital financing. However, SMEs throughout the region are constrained by low turnover, rudimentary administrative and managerial practices, and an acute shortage of risk capital.

6. In the Pacific region, the commercial banking sector is almost exclusively dominated by two Australian institutions, ANZ Bank and Westpac. Commercial banks largely focus on the retail sector through basic deposit-taking and lending activities and on the few large project finance opportunities that arise. Domestic financial sectors provide only a minimal range of banking services; access to credit for local entrepreneurs is limited; and high interest rate spreads reflect high transaction costs and risk premiums, and inefficiencies in financial intermediation. There has been little appetite to complement lucrative retail finance products with higher-risk unsecured commercial loan products. SMEs struggle to qualify for traditional debt financing because few have adequate collateral required to meet commercial banks' stringent lending criteria in the context of an ineffective legal and technical collateral framework.

7. PNG and the Fiji Islands are the two major countries in the Fund's investment region and the majority of the Fund's capital will be invested in these two countries. In PNG, bank lending to the private sector has remained stagnant since the early 1990s, although it has increased somewhat in the last 1–2 years.<sup>1</sup> The credit policies of the formal financial sector are cautious. The banks favor larger clients (many of which are subsidiaries of foreign firms) and short-term investments, particularly in the form of government securities. At the end of 2004, short-term government securities constituted 40% of the asset base of commercial banks. Bank lending is further hindered by the difficulties of land registration and low population density, which increase transaction costs and security concerns.

8. In the Fiji Islands, the capital markets are underdeveloped, even though they are deeper than those of any of the other Pacific region's economies. The South Pacific Stock Exchange in Suva, Fiji Islands, is the only stock exchange of note in the region. There are a number of issues hampering the financial sector's ability to finance investment and encourage savings, such as high interest rate spreads; poor intermediation of remittances; and low levels of credit to the private sector, which only amounts to about 23% of GDP.<sup>2</sup> In addition, lack of adequate collateral for securing loans and the inability of native landowners to mortgage their land because of customary tenure hinders financial intermediation and SMEs' access to credit.

9. When commercial banks lend to SMEs, they often take equity risk for a debt-like return because of the absence of acceptable collateral. There are no providers of capital to complement the provision of financing with value-addition; managerial mentoring; and strategic decision-making, which is needed to mitigate risks and obtain risk-adjusted returns from equity finance, in particular in a market with little managerial and operational sophistication. The result is that there are few and, in some cases, no sources of risk capital available to SMEs in the region.

## **B. Challenges and Opportunities**

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### **1. Building on Investment Experience in the Pacific Islands**

10. Given the overall lack of risk capital, and the past investment experience of Pacific Capital Partners Limited (the Fund Manager) gained by investing and divesting Kula Fund I, the proposed Fund will be well placed to take advantage of some of the more attractive investment opportunities in the marketplace. The Fund plans to invest in the types of companies that could benefit significantly from the hands-on involvement and guidance that the Fund Manager can provide. The Fund Manager will build on its lessons learned in SME investment in the Pacific

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<sup>1</sup> Economist Intelligence Unit. 2005. *Country Report. Papua New Guinea*. London.

<sup>2</sup> ADB. 2006. *Private Sector Assessment for Fiji Islands*. Manila.

islands to actively assist investee companies in developing business plans, improving capital structures, and implementing international standards of corporate governance. Hands-on assistance will also be provided in improving management information systems and human resource development, which will help to produce solid returns to investors while providing investee companies with a strong foundation for sustainable growth and development. In many cases, the transition to more professional management should enable portfolio companies to improve their performance and enhance their value to potential purchasers, thus improving the Fund's chances of achieving profitable exits.

11. A key feature of the proposed Fund is that it will be able to mobilize the relationships it has established in the Pacific region since 1997 to generate investment opportunities. With team members already located in the Pacific region, the Fund Manager has begun to generate a pipeline of potential transactions for the Fund, mobilizing its long-standing network of contacts with senior corporate executives, financial intermediaries, and service providers, such as legal and accounting professionals. Potential investment opportunities for the Fund have arisen in agribusiness, tourism, fast-moving consumer goods, manufacturing, and business-process outsourcing. The Fund will be able to immediately pursue a number of these potential opportunities after its establishment, which will minimize the period where the Fund pays management fees without generating returns from investments. This is crucial for achieving a positive net return in this challenging environment.

## C. Development Impact

### 1. Development Objectives

12. The Fund will build on Kula Fund I's experience and role in contributing to private sector development in the Pacific region. The three case studies show the important contributions that Kula Fund I made in (i) improving access to finance, (ii) private-sector-led development, (iii) introducing best practices in corporate governance, (iv) generating employment, (v) providing basic services such as access to health care and education, and (vi) at a more overarching level, improving living standards through poverty reduction of investee companies' employees.

13. Specifically, by providing financing for Kula Fund II, ADB intends to achieve the following developmental objectives.

- (i) **Capacity building in a narrow financial sector.** The establishment of regional offices and cooperation with financial professionals in remote islands will help to foster local SME investment skills. The Aureos investment philosophy and infrastructure are particularly effective because they combine decentralized decision-making and active support, training, and quality control from headquarters.
- (ii) **Diversify sources of finance available for SMEs.** Given the stringent collateral requirements of banks in the Pacific islands, the inclusion of equity finance will be critically important. It enables SMEs to buy fixed assets, use them as collateral for commercial bank loans, and leverage their expansion. This leverage effect creates a dynamic process promoting SMEs' graduation to larger enterprises, which results in increased employment and productivity.
- (iii) **Building sustainable private sector companies.** The Fund Manager will contribute to the development of sustainable SMEs by providing management advice to SMEs in financial planning, business expansion strategies, human

resource development, and implementation of international standards of corporate governance.

- (iv) **Create sustainable private sector jobs.** Sustainable employment in the Pacific islands will be created through the Fund's investee companies.
- (v) **Support a fund manager with a track record in the Pacific islands.** By managing Kula Fund I, the investment team has gained critically important local investment experience and created a network in the Pacific islands, which can be used to source investments and build sustainable SMEs in the region.

14. In addition to the Fund's direct impact on employment and economic growth, the Fund will contribute to the development of effective regulatory and legal environments in the target countries. The Fund will be required to collect consistent information on regulatory issues that their SME portfolio companies encounter in the Pacific region. This information will be reported on a regular basis to PARD to support the formulation of a regulatory framework conducive to entrepreneurial SMEs.

#### **D. Measuring Development Effectiveness**

15. ADB's Private Sector Operations Department (PSOD) and Operations Evaluation Department (OED) continue to formulate guidelines for implementing Good Practice Standards (GPS) for Evaluation of Private Sector Investment Operations, which were prepared by the Evaluation Cooperation Group<sup>3</sup> of the multilateral development banks. These GPS cover the roles of the independent evaluation department and the private sector department itself, the evaluation dimensions for private sector operations, the nature of annual reporting, and dissemination of reports and lessons. According to the GPS, the three principal dimensions for private sector evaluation are (i) development outcome, (ii) investment profitability for the institution, and (iii) operational effectiveness. PSOD will measure the expected development outcome of this Fund at the fund and sub-project levels, as well as beyond the Fund, by monitoring certain performance measures throughout the life of the Fund. The performance measures are grouped into three key areas.

- (i) **Business performance.** The extent to which the Fund has reached its objectives in terms of the overall profitability and commercial viability of the Fund and subprojects.
- (ii) **Economic sustainability.** The effects of the Fund and subprojects on the DMC's economy, and the associated benefits and costs. On one hand, these measures assess the extent to which the Fund improved the allocation of resources and provision of financial services to viable private enterprises. On the other, these measures evaluate whether the subprojects directly generated positive effects on the local economy.
- (iii) **Private sector development.** The impact of the Fund on private sector development beyond the Fund itself and its immediate stakeholders, e.g., the Fund's contribution to the growth of viable financial institutions and financial markets development.

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<sup>3</sup> 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.



### III. THE FUND

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#### A. Fund Objectives

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16. Kula Fund II will invest in SMEs in the Pacific islands. At least 80% of the Fund's investments will be invested in enterprises in the Cook Islands, Fiji Islands, Kiribati, Marshall Islands, Federated States of Micronesia, Nauru, PNG, Samoa, Solomon Islands, Tonga, Tuvalu, Palau, and Vanuatu. The remaining 20% may be invested in enterprises based elsewhere in the Pacific region,<sup>4</sup> which have, or are expected to have, significant operations and/or create economic benefit within DMCs of the Pacific region. While a significant proportion of committed capital is expected to be invested in PNG and the Fiji Islands, the Fund's overarching objective is to build a portfolio diversified by geography, and no more than 60% of the Fund's total commitments can be invested in enterprises in the Fiji Islands and PNG.

17. The Fund will generally take significant minority stakes with board representation and the right to participate in or influence the conduct of management in its portfolio companies. The size of the Fund's investment in portfolio companies will range from \$100,000 to \$3 million. The Fund will pursue the following investment opportunities:

- (i) expansions of companies with promising growth prospects that are unable to secure financing from traditional sources such as commercial banks;
- (ii) consolidations and associated divestments of discrete business segments as conglomerates refocus on core competences;
- (iii) management buyouts, as local managers seek to take control of recently-divested or newly-privatized companies;
- (iv) start-ups and early stage transactions, particularly in smaller Pacific islands, where local managers are able demonstrate a sound track record;
- (v) growth in agricultural output and exports in response to improved world commodity prices and the implementation of agricultural development policies focusing on niche agriculture, organic and specialty products; and
- (vi) strong growth in the tourism sector underpinned by a perception, particularly among Australian and New Zealand holiday-makers, that terrorist attacks are less likely in Pacific island destinations than in other regions.

18. The Fund's equity commitments may be accompanied by secured debt, mezzanine debt, and/or quasi-equity instruments such as convertible debt and preference shares. Such investment structures offer current income and mitigate the risks related to exiting from portfolio companies in this challenging environment.

#### B. Fund Management

[CONFIDENTIAL INFORMATION HAS BEEN DELETED]

19. **Fund Manager.** The Fund will be managed by Pacific Capital Partners Limited (the Fund Manager), a company with limited liability and incorporated under the laws of Vanuatu, and a wholly-owned subsidiary of Aureos Capital Limited (Aureos), a company incorporated with limited liability under the laws of Mauritius. Aureos is a global manager of SME private equity

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<sup>4</sup> Including Australia and New Zealand.

funds. Aureos was born out of the former Commonwealth Development Capital (CDC) Funds Group, pioneers of private equity in many of the emerging markets in the SME sector. (CDC's first fund, which was established in 1989, and all its subsequent funds, were exclusively invested in developing countries.) When CDC spun out its private equity funds business in July 2001, Aureos was established as a fund manager. Over 10 management companies, originally owned and managed by CDC, which in turn managed 14 SME venture capital country-specific funds, were consolidated under the Aureos umbrella.

20. **Headquarters.** The Aureos headquarters is in London and focuses solely on operating SME funds around the world. Aureos combines local presence with a global network, whereby the central team fulfills the following functions:

- (i) central reporting function ensuring consistency, quality, and timeliness;
- (ii) cross-fertilization between regional teams on global investment themes, and industry-specific and market information;
- (iii) compliance and procedural quality control;
- (iv) overseeing the collection and implementation of lessons learned by providing a central point of information dissemination;
- (v) training and dissemination of best practices in investment management and corporate governance;
- (vi) exit assistance, particularly in finding foreign partners; and
- (vii) cash control supervision.

21. **Local Team.** The local team carries out the main responsibilities of identifying potential investee companies, executing transactions, and monitoring and managing portfolio companies. This local decision-making process is reflected in the Fund's incentive structure, which allocates most of the performance-related rewards (carried interest) to the local team. The track record of Aureos shows that its structure optimizes capacity building of local SME investment skills as it combines decentralized decision making with active support and quality control from headquarters.

22. Soon after the first closing, the Fund Manager will establish a new representative office in Suva, Fiji Islands, while maintaining its existing offices in Port Moresby, PNG, and Brisbane, Australia—which will be the regional hub office. Back-office support will be provided from Brisbane to produce standardized reporting and other management support so that investment partners can focus exclusively on investing and managing the Fund

23. **Technical Assistance.** Taking from lessons learned (investing in the Pacific region is costly and highly human resource intensive), Kula Fund II will have the benefit of TA funds from the Australian Agency for International Development (AusAID), New Zealand's International Aid & Development Agency (NZ Aid), Australian Business Volunteers, and Centre for the Development of Enterprise of the European Union. AusAID and NZ Aid have committed \$150,000 each per annum. TA support will take the form of capacity building, training, export development, and support in the due diligence process. By means of TA funding, the Fund will establish partnerships with local business councils, chambers of commerce, export development agencies, and other relevant organizations to increase awareness among local entrepreneurs of the benefits of risk capital as an asset class and to encourage them to grow their businesses through partnership. This strategy has proved very effective in other small island contexts, notably the Caribbean and the Indian Ocean, as a means of stimulating organic

growth in SMEs and reducing the proclivity in many businesses towards costly borrowing and debt accumulation.

#### **IV. ASSURANCES**

24. Following the approval of the proposed investment by ADB's Board of Directors, ADB will enter into suitable investment documentation and shall ensure that such documentation and other principal agreements relating to the Fund (including the management agreement between the Fund and the Fund Manager) shall be on terms and conditions acceptable to ADB and incorporate all relevant ADB policies.

#### **V. RECOMMENDATION**

25. I am satisfied that the proposed investment in Kula Fund II as described in this report complies with the Articles of Agreement of ADB and acting in the absence of the President, under the provisions of Article 35.1 of the Articles of Agreement of ADB, I recommend that the Board approve the investment in Kula Fund II of up to the lesser of \$5 million or 25% of the Fund's total share capital from ADB's ordinary capital resources.

Liquan Jin  
Vice President, Operations 1

7 June 2006

## PERFORMANCE MEASURES FOR DEVELOPMENT OUTCOMES

### A. Business Performance (Fund)

| Concept              | Impact  | Performance Measures (Qualitative and/or Quantitative)   |
|----------------------|---|--|
| Financial objectives | <ul style="list-style-type: none"> <li>▪ Overall profitability of the Fund</li> </ul> | <ul style="list-style-type: none"> <li>▪ Gross internal rate of return (database)<sup>a</sup></li> <li>▪ Net internal rate of return (database)</li> </ul> |

### B. Economic Sustainability (Fund and Subprojects)

| Concept   | Impact   | Performance Measures (Qualitative and/or Quantitative)   |
|---|--|--|
| Efficient allocation of finance and/or provision of financial services to economically viable enterprises | <ul style="list-style-type: none"> <li>▪ Subproject economic performance</li> <li>▪ Stronger local entrepreneurship</li> <li>▪ Contribution to widening SMEs' access to finance</li> <li>▪ Provision of value-added services, enhancing the viability of SMEs</li> </ul> | <ul style="list-style-type: none"> <li>▪ Annual net profit of subproject (database)</li> <li>▪ Annual net revenue of subproject (database)</li> <li>▪ Number of entrepreneurial projects receiving finance from the Fund (database)</li> <li>▪ Number of returning entrepreneurs and skilled workers from industrialized countries receiving finance and transferring skills (database)</li> <li>▪ Additional debt raised by subprojects as a result of the equity investments (database)</li> <li>▪ Number of enterprises advised (database)</li> <li>▪ Quality of advice in financial planning, expansion strategies, human resource development, accounting standards, corporate governance, and management training (PCR)</li> </ul> |
| Additional direct contributions of subprojects to the local economy                                       | <ul style="list-style-type: none"> <li>▪ Contribution to government revenues</li> <li>▪ Employment generated</li> <li>▪ Adoption of new technologies and production processes</li> </ul>   | <ul style="list-style-type: none"> <li>▪ Increased amount of taxes paid by subprojects (database)</li> <li>▪ Number of jobs created by subprojects (database)</li> <li>▪ Quality of jobs created by subprojects e.g., technical jobs (PCR)</li> <li>▪ Increased investment in new technologies and/or in improvement of production processes by subprojects (PCR)</li> <li>▪ Number of subprojects implementing successful new technology (PCR)</li> <li>▪ Increased quality/lower price of subproject's product because of investment in technology (PCR)</li> </ul>  |

### C. Private Sector Development (Impact beyond Fund and Subprojects)

| Concept  | Impact  | Performance Measures (Qualitative And/Or Quantitative)   |
|--|---|--|
| Contribution to the growth of viable financial institutions and financial market development | <ul style="list-style-type: none"> <li>▪ Positive impact on regional integration</li> <br/> <li>▪ New technology, development of management skills, and employee training in domestic financial sector</li> <br/> <li>▪ Resource mobilization through private equity</li> <br/> <li>▪ Growth in financial services in the domestic financial markets<sup>b</sup></li> </ul> | <ul style="list-style-type: none"> <li>▪ Number of companies enabled to expand regionally through the Fund's provision of equity capital</li> <li>▪ Number of companies enabled to expand regionally through the Fund's support in upgrading management systems</li> <br/> <li>▪ Number of local investment professionals in SME private equity trained by the Fund (PCR)</li> <li>▪ Number of Fund's investment professionals raising a subsequent fund in financial sector of a DMC (PCR)</li> <br/> <li>▪ Mobilized domestic finance for investments in productive SMEs by the Fund (at closing of the Fund)</li> <li>▪ Mobilized international finance for investments in productive SMEs by the Fund (at closing of the Fund)</li> <br/> <li>▪ Growth in private equity market in the domestic financial sector (PCR)</li> <li>▪ Increased access to long-term finance (PCR)</li> </ul> |

DMC = developing member country, PCR = project completion report, SME = small and medium-sized enterprise.

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

Performance measures followed by "(PCR)" will be measured at the PCR stage.

<sup>b</sup> 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.